In The

Supreme Court of the United States

OCTOBER TERM, 1937

NOS. 144 AND 145.

D. B. HEINER, Individually and as Former Collector of Internal Revenue for the Twenty-third District of Pennsylvania, Petitioner,

v.

PAUL MELLON, DAVID K. E. BRUCE, and DONALD D. SHEPARD, Executors of the Estate of A. W. MELLON, Deceased, Respondents.

D. B. HEINER, Individually and as Former Collector of Internal Revenue for the Twenty-third District of Pennsylvania, Petitioner,

v.

JENNIE KING MELLON, RICHARD KING MELLON, SARAH MELLON SCAIFE, and THE UNION TRUST COMPANY OF PITTSBURGH, Executors of the Estate of R. B. MELLON, Deceased, Respondents.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR RESPONDENTS.

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February, 1938.

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BRIEF FOR RESPONDENTS.

COUNTER-STATEMENT OF QUESTIONS PRESENTED.

1. When a partnership is dissolved by the death of a partner, is any taxable gain realized by the partners during its liquidation until the amount received by the respective partners from the sale of assets exceeds the cost bases of the respective partnership interests?

2. When a partnership is dissolved by the death of one of the partners, do the surviving partners become liquidating trustees and taxable as a separate entity?

3. Can the petitioner maintain an equitable defense in the nature of a plea of estoppel when there has been no misrepresentation or concealment of any fact by respondents; that with full knowledge of all facts the Commissioner of Internal Revenue has assessed and petitioner has collected from the taxpayers taxes on the same income in two different years; that neither the Commissioner of Internal Revenue nor the Federal Government has ever tendered return of the tax for either year; and that the Commissioner has shifted back and forth from one legal position to another to the detriment of respondents?

COUNTER-STATEMENT.

On December 12, 1918, A. W. Mellon, R. B. Mellon and H. C. Frick, the only stockholders of A. Overholt & Co. and West Overton Distilling Company, two corporations, each of which had been engaged in the business of distilling whiskey and had on hand large stocks of whiskey, formed two partnerships under the same names to take over the assets of the corporations. (Fdg. 8, R. 150, 15-19, 321, 365, 369; Ex. 3; R. 351 d). No additional stock of whiskey was to be manufactured or purchased. (Fdg. 13, R. 152).

The partnership agreements provided in part (R. 44):

> "In case of the dissolution of the firm by death of one or more of the partners, the remaining member or members shall have full power and authority to appoint such person or persons (including incorporated companies) as liquidating agent, with such power and authority to wind up and liquidate the affairs of said partnership as to such surviving partner or partners shall seem advisable."

The partnerships began business January 1, 1919, and were dissolved by the death of Mr. Frick on December 2, 1919. No new partnership agreements were thereafter entered into. (Fdgs. 8, 9, R. 151, 321, 335).

Immediately after the dissolution of the partnerships the surviving partners, A. W. Mellon and R. B. Mellon, who will be hereinafter referred to as the "respondents," began the liquidation of the two partnerships, and from that time, December 2, 1919, until January 31, 1921, acted as liquidating trustees in respect to the assets and businesses of the two former partnerships. (Fdg. 10, R. 151). In the process of liquidation no distilling operations were carried on and whiskey was sold by certificate until the end of 1920, at which time the surviving partners decided not to sell any more certificates unless they could sell all of the whiskey to some one person or concern. During 1920, bottling and storage operations were carried on as incidental to the sale of whiskey certificates and the withdrawal of the whiskey. (R. 354-55). On January 31, 1921, The Union Trust Company of Pittsburgh was appointed liquidating agent for the partnerships and all the remaining assets were transferred to it for that purpose. (R. 19-32, Fdg. 10, R. 151). The distilleries and whiskey were finally sold in the year 1925. (R. 324, 337-38, 353-56).

At the time of Mr. Frick's death, December 2, 1919, and during the period of liquidation from 1919 to 1925, there were debts and large contingent liabilities outstanding against the partnerships and no distribution of assets could have legally been made either by the liquidating trustees or by the liquidating agent later appointed by them, until the debts and contingent liabilities had been released, paid or satisfied. (Fdg. 14, p. 152, Ex. 2; R. 350 and R. 369-79).

The surviving partners kept the assets of the partnerships, including cash, separate from their individual interests and did not commingle such assets or cash with their own assets or cash. (R. 325, 388, admitted in the pleadings and in evidence; Fdg. 15, R. 152; finding requested by petitioner, Request 9, R. 630, 654).

The books and records of the individual taxpayers were kept and their income tax returns were filed on the cash receipts and disbursements basis of accounting. (Fdg. 3, R. 149, 319, 333-34). The books and records of the two partnerships were kept on the accrual basis of accounting. (Opinion of Court, R. 159, 173).

No distribution of any profits and no return of capital was made by the surviving partners or by the liquidating agent to the surviving partners as individuals or to the estate of the deceased partner during the year 1920 or during any year until after final liquidation in 1925 when the partnership assets were sold to outside parties. (Fdgs. 12, 14, 18, R. 152-53, 356-58, 366). Liquidation of the two partnerships was finally consummated and distribution was made by the liquidating agent to the surviving partners and to the estate of the deceased partner in the year 1925. (Fdg. 12, R. 152, 323, 337).

Income tax returns for the year 1920 were filed on behalf of the two partnerships in liquidation by R. B. Mellon, one of the surviving partners, on partnership forms. The returns disclosed that the partnerships were in liquidation because of the death of Mr. Frick, reported the income realized from bottling, storage and sale of barrels, and computed tax thereon, and also disclosed a computed profit on the sale of whiskey certificates which was not reported as income but claimed to be the proceeds from the conversion of capital assets and not reportable as income until such proceeds exceeded the cost

bases to the former partners of their partnership interest. (Exs. 3, 4; R. 351, 352).

On the individual income tax returns filed by the surviving partners for 1920, each took up and returned as income his undistributed share of the reported income of A. Overholt & Co. and West Overton Distilling Company from bottling, storage, etc. (R. 326, 340) in the amount of $48,350.75 for A. Overholt & Co. and $5,960.55 for West Overton. (Fdg. 17, p. 153). No part of the proceeds from the sale of whiskey certificates was returned by the individuals for 1920. However the Commissioner increased the amounts so returned by each partner to $281,779.95 for A. Overholt & Co. and $52,814.28 for West Overton, on the theory that a taxable profit was realized in 1920 from the sale of whiskey certificates. (R. 327, 340, 387, 388, 395-97). (Fdgs. 5, 6, 7, R. 150).

In 1927 the Commissioner assessed additional taxes for 1920 against the surviving partners, aggregating with interest $202,502.20 against A. W. Mellon and $187,-887.17 against R. B. Mellon, which were paid under written protest on April 2 and May 19, 1927, respectively. (R. 320, 335).

The alleged profit from the sale of whiskey certificates for 1920, as computed and taxed by the Commissioner (A. Overholt & Co., $233,429.21, R. 387, West Overton Distilling Company, $46,853.73, R. 388), did not exceed the cost bases of the former partners' interests in the partnerships, which were $990,775.53 and $60,505.66, respectively. (Fdg. 23, R. 154, Exs. BB. CC; R. 495-96, 501-02).

After the Commissioner had assessed and collected the alleged additional tax for 1920, he, on or about November 14, 1928, reversed his ruling of 1927 and held that the liquidation of the two partnerships was consum-

mated in 1925, that the reported profits and losses for 1924 should be eliminated, and that taxable income for 1925 should include the difference between the cost values of the partners' interests as of December 2, 1919, and the amounts received in final liquidation, including all reported and alleged profits and losses for the years 1920 to 1924, inclusive. On this basis deficiencies for the year 1925 were accordingly assessed by the Commissioner and paid by the surviving partners on June 13, 1929. (Fdgs. 19, 20, R. 153-54, 328-31, 341-42, 345; Exs. BB, CC, FF; R. 495, 501, 508 a). In assessing the tax for 1925, the Commissioner included in income the alleged profit from the sale of whiskey certificates in 1920 on which a tax had previously been assessed by him for the year 1920, and paid by the surviving partners in April and May, 1927, as above stated. (Fdg. 24, R. 155).

The Commissioner has twice collected a tax on the identical income by including it first as income for the year 1920 and later as income for the year 1925. (R. 332).

The Commissioner determined and settled the income tax liability of the Estate of Henry C. Frick, the deceased partner, for the years 1920 and 1925 by holding that the so-called profits of A. Overholt & Co. and West Overton Distilling Company for the year 1920 did not constitute taxable income in that year but did constitute taxable income in the year 1925, the year in which final distributions and liquidations were made, and the estate of the deceased partner paid the tax on that basis. (R. 325-26, 339, 600-15). This settlement was first discussed in a letter from the Bureau of Internal Revenue dated December 14, 1927 (Ex. 6; R. 605), and was finally made in 1928. The contents of the said letter were communicated to the attorney for the surviving partners, and the Commissioner's representatives in Washington

were advised that such a ruling would be satisfactory to the surviving partners and a similar ruling could be made as to them. (R. 604-610).

Claims for refund of the 1920 tax were filed by the surviving partners on March 19, 1929 (Fdg. 21, R. 154, 331, 346), four days after the Commissioner had issued his final deficiency letter for the year 1925 in which he proposed to assess the tax on all the income from the liquidation in the latter year. (Fdg. 20, R. 154).

The claims for refund of the 1920 tax were not rejected until April 6, 1934 (R. 402; Ex. V, R. 479), more than five years after the filing thereof and two years after these suits had been instituted. (Fdg. 22, R. 154).

On July 16, 1931, more than two years after the filing of the claims for refund of the 1920 tax, the Commissioner again reversed his position, and as to the year 1924, included in the taxable income of the surviving partners the so-called operating profits and losses realized from bottling, storage, etc., during the liquidation of the two former partnerships. (R. 481-82).

Protective claims for refund of income tax for 1925 were filed by both taxpayers on or about May 11, 1932 (Exs. FF, GG; R. 508-10), but the Commissioner, notwithstanding the fact that he has collected taxes on the same income in both 1920 and 1925 has not acted on the claims nor tendered any refund of tax for either year. There is no evidence as to why the claims have not been acted upon and the Court made no finding of fact on this point.

The District Court entered judgments in favor of the respective plaintiffs, holding that the receipts from the sale of certificates in 1920 were not taxable as profits in that year but constituted a sale of capital assets and were taxable on final liquidation in 1925. These judg-

ments were affirmed by the Circuit Court of Appeals for the Third Circuit.

Additional Facts With Respect to the Equitable Defense.

No question as to the equitable defense of petitioner arises unless the Court should determine that the alleged income in question was taxable in 1920. The Trial Court made no special findings relating particularly to this defense as it held the question to be moot in view of its decision that no taxable income was realized from the sale of whiskey certificates in 1920.

The fact that the partnerships were in liquidation in 1920 was made known to the Commissioner by the income tax returns filed by the two dissolved partnerships for that year. (Exs. 3, 4; R. 351-52). The returns for both former partnerships and of both the surviving partners were examined and the books of account and the records audited at the same time by the same Revenue Agent, Albert W. Smith, and his reports on all four returns are dated November 8, 1921. (Exs. C, D, K, L; R. 444-50). These reports on the former partnerships refer to each other. The return filed by A. Overholt & Co. leaves blank the answer to the questions stated on the first sheet, to-wit: "Kind of Business" and "State Whether Partnership or Corporation," and stated that it is a "partnership in liquidation," and on a special schedule attached thereto, the following appears:

> "The Partnership of A. Overholt & Co. consisted of A. W. Mellon, R. B. Mellon and Henry C. Frick and was created on December 30, 1918, for the purpose of liquidating the assets of A. Overholt & Co., a Pennsylvania corporation.
>
> "Mr. Frick died on December 4, 1919, and, under the laws of the State of Pennsylvania, Messrs. A.

W. and R. B. Mellon were, as surviving partners, required to carry on the liquidation of the assets of the copartnership.

"On February 1, 1921, Messrs. Mellon, as liquidating partners, transferred all of the assets, real, personal and mixed of the copartnership, to The Union Trust Company of Pittsburgh, as liquidating agent." (R. 351 d).

The return of West Overton Distilling Company (Ex. 4; R. 352) stated in answer to question 3 (b), that it is "in liquidation."

The Revenue Agent's report on A. Overholt & Co. for 1920 (Ex. K; R. 448) stated that the taxpayer had set aside a portion of profits under the caption of liquidation, claiming it as a return of capital.

The legal point that the surviving partners became as a matter of law liquidating trustees and, as such, taxable as separate entities, was argued in a brief filed on November 22, 1932 (Ex. LLL; R. 572), and then only after the Commissioner had refused to act upon the claims for refund for 1925, which were filed as a protective measure. (Exs. FF, GG; R. 507-10).

There was no concealment or misrepresentation of any fact. The Commissioner knew of Mr. Frick's death and had full knowledge that A. W. Mellon and R. B. Mellon were liquidating the former partnerships; he made a settlement with the Frick Estate on the basis that the so-called profits of both former partnerships for the year 1920 did not constitute taxable income in that year, but did constitute taxable income in the year 1925, and the Frick Estate paid the tax on that basis. (Fdg. 16, R. 152, 325-26, 339, 600-15; Ex. 6).

The Commissioner's inconsistent determinations with respect to the net income during the period of liqui-

dation of A. Overholt & Co. and West Overton Distilling Company are respectively set forth in letters written by him as follows:

1. All profit, whether from bottling or otherwise, was taxable income in 1920. (Letters of February 9, 1922; Exs. C, D; R. 444, 446).
2. No profit, whether from bottling or otherwise, was realized until final liquidation. (Frick Estate ruling—Letter of September 14, 1927, Ex. 6; R. 605, Fdg. 16).
3. No profit, whether from bottling or otherwise, was realized until final liquidation. (Letter of November 14, 1928, as to 1924, R. 328, 341-42, Fdg. 19).
4. All profit was realized upon final liquidation as capital net gain. (Notice of Deficiency for 1925, March 15, 1929, Exs. BB, CC; R. 491, 497, Fdg. 20).
5. Profit on sale of whiskey was realized and taxable in 1920. (Letters dated April 16, 1932, Exs. T and U; R. 475-77; letters dated February 27, 1934, and April 6, 1934, Exs. W and V; R. 479-80). See also similar letters to A. W. Mellon (R. 401-02).

The Commissioner did not reverse his determination that all profit was realized and taxable upon final liquidation in 1925 until after the praecipes for summons had been issued in the instant cases, nor did he actually disallow the claims for refund until approximately two years after the filing of the praecipes herein and after the statements of claim had been filed in the instant cases.

The Commissioner has not acted on the claims for refund of income tax for the year 1925 filed by the taxpayers, nor has he tendered any refund of tax for either

the year 1920 or the year 1925 or given to respondents any reason for his failure to act or make tender.

On or prior to December 31, 1925, and prior to the date of the additional assessments for both 1920 and 1925, all of the moneys, properties and assets of whatever nature of A. Overholt & Co. and West Overton Distilling Company were distributed to the surviving partners and the Estate of H. C. Frick, leaving said partnerships with no assets or property. (R. 390, 398). During the liquidation, various sums of money were loaned by the trustees to the partners and the estate of the deceased partner. These loans were not in proportion to the partnership interests, were carried on the books of the partnership as bills receivable, and repayments were duly credited to the same account. Any balance due on the loans was repaid when the partnership property was sold. The Trial Judge, in his opinion, held that the sums so advanced were loans and were not paid out in distribution of the gains of the partnerships (R. 159). In his many tax determinations the Commissioner has never taken the position that these loans were taxable as distributions of profits.

Petitioner contends the two partnerships continued in existence as partnerships during 1920 and that the surviving partners were not taxable as trustees, separate taxable entities. The District Court held that whether or not appellees were taxable as separate entities, *i. e.,* trustees, was moot in view of the fact that no taxable gain was realized in 1920 upon the sale of whiskey certificates. (R. 174-76). The Circuit Court of Appeals, in affirming the lower court, held there was no basis for applying the doctrine of either legal or equitable estoppel as there was at most a mutual mistake of law.

SUMMARY OF ARGUMENT.

The two partnerships were dissolved by the death of Mr. H. C. Frick on December 2, 1919, and thereafter until all the assets were sold in 1925 no business was carried on except that incidental to the conversion of the assets of the dissolved partnerships into cash and the payment of the partnerships' debts and obligations. Upon the dissolution of the partnerships by the death of Mr. Frick the interests of the partners became capitalized. No taxable income was realized by the surviving partners from the sale of whiskey certificates during the year 1920, as these certificates did not constitute stock in trade but were capital assets, and the proceeds of such sales did not constitute taxable income until the amount received therefrom exceeded the cost base of the partners' interests. Article 1570 of Treasury Regulations 45 promulgated under the Revenue Act of 1918 so provides. It has been incorporated in subsequent Regulations and the provisions of the act under which it was promulgated have been reenacted in subsequent acts. The Regulation, therefore, has the force and effect of law. The deferment of the realization of taxable income is a well recognized concept of the theory of income taxation. It does not create evasion or avoidance but merely postponement, and does not distort either a taxpayer's income or the revenues of the Government.

The Commissioner having determined that the interests of Mr. Frick in the partnerships were taxable in 1925 and having assessed and collected a tax on that basis in the year of final liquidation and having also determined that the interests of respondents in the two partnerships were likewise taxable in 1925 and having assessed and collected a tax on that basis, he cannot now claim that the respondents realized taxable income

in 1920 on the sale of the capital assets of dissolved partnerships in liquidation.

In no event can it be determined whether taxable gain was realized or loss sustained until liquidation is complete, as all the debts and obligations of the partnerships and the expenses of liquidation must be paid before any distribution can be made to the surviving partners or to the estate of a deceased partner.

Findings of fact concurred in by two lower courts will be accepted unless clear error is shown. The findings of the lower courts that the cost base had not been recovered in 1920 is supported by the evidence. The ultimate fact having been found, recital by the court of circumstantial or evidentiary facts is not required.

The death of Mr. Frick dissolved the partnerships and the surviving partners became, by operation of law, liquidating trustees of the partnerships, with a duty to account as trustees on completion of the liquidation. As such trustees they were not required to complete the liquidation immediately but were entitled to a reasonable time within which to do so. No distributions could have been made by the liquidating trustees until all debts and liabilities, contingent or otherwise, had been paid or satisfied or other provision made therefor.

If this Court should consider that taxable income was realized in 1920 from the sale of whiskey certificates by the dissolved partnerships in liquidation, judgment should be affirmed on the ground that the tax, if any, should have been assessed against and paid by the liquidating trustees as separate taxable entities and not by the surviving partners as individuals or as beneficiaries of the trusts. The Revenue Act of 1918 sets up a comprehensive plan for the taxation of the income of estates

or of any kind of property held in trust and it covers the fiduciary of a trust created by operation of law as well as the fiduciary of an express trust. The term "fiduciary" as defined in section 200 of the act is broad enough to cover every conceivable type of fiduciary, including surviving partners liquidating a partnership dissolved by death.

The taxing authorities had full information from the returns and from the examinations and audits of the records of the dissolved partnerships and of the surviving partners of the fact that Mr. Frick had died and that the partnerships had been dissolved and were in liquidation. The Commissioner was bound to assess the tax correctly. Assessment and collection of the tax against the liquidating trustees as separate taxable entities are barred by the statute of limitations. That fact was expressly pleaded by petitioner, admitted by respondents' reply and read into evidence. Therefore, the question is not before this Court since the United States is bound by the admissions of its counsel.

The Commissioner having had full information as to all necessary facts, the respondents are not estopped to contend that the tax for 1920, if any was due, was payable by the liquidating trustees as separate taxable entities and not by the surviving partners as individuals. The Commissioner assessed and collected a tax against the individuals on alleged profits for the year 1920 and again assessed and collected a tax on the same alleged profits for the year 1925 in which year liquidation was completed, and has refused to refund either tax. The present case is clearly distinguishable from *Stone v. White*, 301 U. S. 532, on which petitioner strongly relies.

The Commissioner did not rely on the returns filed by the partners which assumed that the tax was payable in the year of final liquidation, but assessed and collected a tax on the alleged profits in the year 1920, later reversed his position and assessed and collected a tax on the same profits for the year 1925, and again after suit was brought, returned to his first position and claimed that the tax was properly assessed and collected for the year 1920. The Commissioner cannot claim to have been misled by reliance on the conduct of the surviving partners as he not only did not rely upon it but made his assessments directly contrary to the position taken by the respondents in their returns. There was at most a mutual misunderstanding of the law as to the taxable liability of the surviving partners and the liquidating trustees, and where both parties labor under a mistake of law there is no estoppel. The Government cannot avail itself of the defense of estoppel, a pure equitable defense, when taxes have been assessed and collected on the same identical income in two separate years and no refund or tender of refund has been made for either year. The equities are all with respondents.

ARGUMENT.

I.

No Taxable Gain Was Realized in 1920 on the Sale of Whiskey Certificates by the Dissolved Partnerships in Liquidation.

The District Court found that no taxable gain was realized in 1920 from the sale of whiskey certificates for the reasons: (1) The partnerships were dissolved by the death of Mr. Frick, were in process of liquidation during that year and the whiskey sold was a capital asset from which no gain was realized until the proceeds of sale exceeded the cost of the interests of the partners; and (2) The surviving partners were trustees with the duty of accounting upon the termination of the liquidation, which was not and could not reasonably have been completed in 1920.

Respondents contend, and the lower courts held, that all the disputed items were capital; there was no way to determine whether any part thereof was gain until the dissolution process was complete; and that these items did not become a part of the profits until the final liquidation in 1925. The petitioner collected the tax on the final wind-up of the partnerships in 1925 as contemplated by the Commissioner's long-standing regulations, i. e., the individual partner's cost over the amount realized through liquidation.

In support of the District Court's findings and conclusions we cite the following law and evidence:

(1) Article 1570 of Regulations 45, first promulgated under the Revenue Act of 1918 and still in force, which provides:

"When a partner retires from a partnership, *or it is dissolved,* he realizes a gain or loss measured by the difference between the price received for his interest and the cost to him or (if acquired prior thereto) the fair market value as of March 1, 1913, of his interest in the partnership, including in such cost or value the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid." (Italics ours).

(2) The Commissioner's own determinations in 1928 and 1929 that no profit was realized until final liquidation in 1925. (R. 328-31; Exs. BB, CC, R. 491, 497).

(3) A similar determination and settlement made by the Commissioner with respect to the estate of Mr. Frick, the deceased partner. (R. 325-26, 600-13).

Article 1570, which was first promulgated under the Revenue Act of 1918, has appeared in all subsequent Regulations as follows: Regulations 62, Article 1570; Regulations 65, Article 1603; Regulations 69, Article 1603; Regulations 74, Article 604; and Regulations 77, Article 604.

Article 71 of Regulations 45 provides that "The term 'gross income' as used in the act does not include those items of income exempted by statute or by fundamental law." A return of the cost of property or capital invested in property has an exempt status resting in "fundamental law." *Law of Federal Income Taxation, Paul & Mertens,* Vol. 1, § 5.19.

There is no question that the death of Mr. Frick dissolved the partnerships. This is admitted by peti-

tioner. (Brief, p. 32). Therefore, when Mr. Frick died, the surviving partners and the estate of Mr. Frick came within the provisions of Article 1570, and under the Regulation promulgated by the Treasury Department the base for determining gain or loss to them was the cost of their partnership interests plus the amount of their share in any undistributed partnership net income on which the income tax had been paid. The base is not in dispute as the respondents have accepted the Commissioner's figure of $990,755.53. (Exs. BB, CC). Their gain or loss was to be measured by the difference between the price received for their interests and the base.

The petitioner argues that the income tax is an annual tax and cannot be postponed. Therefore, he would apply the unit cost rule to the sale of whiskey certificates. The unit cost basis is generally used in determining the profits of a going business, and in connection with sales and exchanges made in the ordinary course of business, but it is not a conclusive rule nor is it founded upon any specific statutory provision, and it must give way to fundamental law. The unit cost basis is a rule of accounting designed to reflect correctly the income of a going business but should not be applied indiscriminately. In cases, such as installment sales and liquidation of capital assets, the rule cannot be applied so as properly to reflect current income. The Commissioner recognized this principle in the case of partnership assets being liquidated upon dissolution of a partnership and accordingly promulgated Article 1570 above cited, which disregards the unit basis of accounting. Most certainly the unit cost basis is not to be used when the Regulations provide for another method. It was not used in *Burnet v. Logan,* 283 U. S. 404, 75 L. Ed. 1143, which involved a contract for removal of ore over a period of years. It is not used in determining profits on

long-term contracts. It is not used in determining gain or loss to a stockholder on liquidation of a corporation even when the liquidation is accomplished by a series of liquidating dividends spread over a period of years. (Article 1548 of Regulations 45, and corresponding Articles of all subsequent Regulations).

It is true also that the income tax is an annual tax, but it is not true that profit or taxable gain must be determined every year nor that profit cannot be deferred for taxation purposes. Taxable income is deferred where a corporation contingently credits its employees with bonus stock, available after five years of employment. (Article 53 of Regulations 45). Taxable profit is deferred in the case of installment sales and sales on deferred payments. It was deferred in *Burnet v. Logan, supra.* It is deferred in certain types of reorganizations. Section 330 of the Revenue Act of 1918 and corresponding sections of subsequent acts set forth a comprehensive and well-considered Congressional scheme for tax deferment in certain types of cases.

Other instances in which income is deferred may be found in the following cases: *Thomas Bemis, Sr.,* 2 B. T. A. 255; *Edward J. McDonnell,* 4 B. T. A. 49; *C. E. Gullett,* 31 B. T. A. 1067; *Old Colony Trust Co. v. Commissioner,* (C. C. A. 1) 59 F. (2d) 168; *Corn Exchange Bank v. United States,* (C. C. A. 2) 37 F. (2d) 34; *Commissioner v. Tyler,* (C. C. A. 3) 72 F. (2d) 950; *Helvering v. Tex-Penn Oil Company,* 300 U. S. 481; *North American Oil Consolidated v. Burnet,* 286 U. S. 417.

It is apparent that to apply such a rule of accounting in order to determine a profit on the liquidation of assets of a dissolved partnership would be not only inequitable both to taxpayers (in case of gains) and to the Government (in case of losses) but would most likely

result in distorting the true income or profit of taxpayers. The petitioner's argument as to the taxation of annual income clearly does not apply in this case.

The only correct way to determine whether the liquidation of assets of a dissolved partnership has resulted in profit is to wait until the conclusion of the liquidation —deducting all capital items and expenses, making proper valuation and other adjustments, and treating the balance as profit.

We contend that the cost of a capital investment must first be restored from the proceeds of sale before there is gain taxable as income, and that "in order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration." *Burnet v. Logan, supra; Doyle v. Mitchell Bros. Co.,* 247 U. S. 179, 62 L. Ed. 1054. The conversion of the assets into cash does not result in taxable income until the proceeds exceed the cost base. *Allen v. Commissioner,* 49 F. (2d) 716, cert. denied 284 U. S. 655, 76 L. Ed. 555.

In *Glenn v. Weill,* 319 Pa. 380, 383, the Supreme Court of Pennsylvania, in discussing distribution after dissolution of a partnership, quoted with approval from *Adams v. Hubbard, infra,* as follows:

> "'* * * there must be a return of the firm capital to the partners contributing it, in order that there may be a distribution of the profits.'"

In *Wood v. Wood,* 312 Pa. 374, the Supreme Court of Pennsylvania held that death dissolved the partnership; that the partners' interests immediately became fixed as capital; that profits of the partnership received

during liquidation were distributable upon final liquidation between the partners in the proportion of their respective capital contributions and not on the basis on which income was divided prior to dissolution.

In *Adams v. Hubbard,* 221 Pa. 511, 517 (1908), where a partnership had been dissolved by the death of a partner and the question of distribution of assets arose, the Court quoted with approval from *22 Am. & Eng. Ency. of Law* (2d ed.), 86, 87, as follows:

> "* * * 'Where a partnership is dissolved and its affairs are wound up, there must be a return of the firm capital to the partners contributing it, in order that there may be a distribution of the profits. *Each partner's contribution is regarded as a firm debt to such partner, which must be repaid before there are any profits to be divided.* Where one partner has advanced capital in excess of another, the amount advanced is a preferred claim upon the property of the firm. The distribution of capital upon dissolution is in the same proportion in which such capital was furnished.'" (Italics ours).

In *Heiden v. Beuttler,* 11 F. Supp. 290, 291 (N. D. Iowa, 1935), the Court said:

> *"It is fundamental that on the death of a member of the partnership that the partnership is dissolved, but that the surviving partner may, as trustee for the partnership, proceed to wind up the affairs of the partnership and that the property of the partnership first belongs to, and must be used for the payment of debts of, the partnership, and that the rights of the partners therein as individuals are only as to any balance that may remain after the payment of such indebtedness.* As a corollary to this rule, a creditor must first look to the firm property for the payment of obligations due

> from the partnership before such creditor may ask the partners individually to pay any such obligation." (Italics ours).

Accordingly, under the decisions, there was no profit accruing to the former partners in 1920 in which they had a right to possession, yet the petitioner is contending that the proceeds from the liquidation of partnership assets in that year should be treated as if earned by the individuals, although they were not entitled to enjoyment and had no right to treat them as their own. There was a legal restriction on the disposition of the proceeds from such assets. As regards the proceeds from the sale of whiskey certificates in 1920, it was highly speculative as to whether or not the individuals were entitled to share in these proceeds, nor could the amount to which they might be entitled be reliably or accurately estimated. On the contrary, it was reasonably probable that a large amount of money would have to be paid to discharge debts of the partnership and contingent liabilities. Even if a profit was realizable in 1920, they did not receive such profits as individuals under a claim of right to such, but received money as trustees. Such moneys were not unqualifiedly subject to their demands until all debts and contingent liabilities were discharged. There was no economic enjoyment by the surviving partners of the funds which came into their hands as liquidating trustees.

The partnership agreement contemplated liquidation on the death of a partner, and the total cessation of all business except that incidental to the winding up of the partnership affairs (R. 19). What, then, did the former partners own at the death of Mr. Frick? They had an undivided interest in distilleries and a stock of whiskey. There was no occasion for inventories because there was no current turnover of goods manufactured.

The former partners had long before ceased to manufacture. The stock of whiskey was to be sold as a lot or otherwise, without replacement. This was not a situation for a unit rule method to account for profit.

The amount or price received for the partners' interests could not be determined until final liquidation. Using the unit cost basis, the petitioner contends that the surviving partners realized a profit on the sale of whiskey certificates, on bottling operations, storage and sale of barrels. On the unit cost basis a profit could be computed mathematically but who could tell in 1920 whether on final liquidation the amount received would have equalled the cost base or that such mathematically computed profit correctly reflected net income? What if the Government had seized, confiscated and destroyed all whiskey in 1921 or 1922? What if the distilleries had been forced to bottle all whiskey and immediately pay the Internal Revenue tax of $2.20 per gallon? What if the price of liquor had dropped below cost? What if the restrictions on use and sale had been tightened so that it would have been impossible to sell the distilleries and whiskey in bulk and the carrying charges were such that the whiskey could only be kept at a loss, or sold at a loss, or destroyed to mitigate loss? What if the distilleries and whiskey had been sold at such a loss in 1925 that, even considering the alleged profit in 1920, the net result would have been a loss? In any of these events, any one or more of which might have occurred, could it then have been said that respondents realized gain in 1920 when in 1925 the net result of liquidation showed a return of capital less than cost?

Under the law of Pennsylvania, the surviving partners were without authority to distribute any part of such receipts and the proceeds from sales in liquidation

were held subject to payment of all partnership debts and liabilities. (*Infra*, pp. 44-48).

The two partnerships were in liquidation and were entitled to recover back their capital, that is, their tax base, before they realized any profit subject to tax. By Article 1570, the Regulations above cited have consistently recognized that the cost of a partner's interest in the partnership business becomes capital to the partner on dissolution. These Regulations are not in conflict with any statutory provision relating to the question. They are reasonably within the intent of the taxing statute and do no violence to the letter or spirit of the Act. The statute has been re-enacted without change. They therefore ought not to be disturbed, unless plainly wrong. *Universal Battery Co. v. United States,* 281 U. S. 580, 583, 74 L. Ed. 1051; *Northwest Utilities Securities Corp. v. Helvering,* 67 F. (2d) 619, 621; *Robertson v. Downing,* 127 U. S. 607; *Edwards' Lessee v. Darby,* 12 Wheat. 206; *Brewster v. Gage,* 280 U. S. 327, 74 L. Ed. 457, 462, and cases there cited.

By successive re-enactments of the Statute without change, these Regulations have become law. *Massachusetts Mutual Life Insurance Co. v. United States,* 288 U. S. 269; *Old Colony R. R. Co. v. Commissioner,* 284 U. S. 552; *Poe v. Seaborn,* 282 U. S. 101; *Wisconsin v. Illinois,* 278 U. S. 367, 413.

Article 1570 of the Regulations was considered by the Circuit Court of Appeals for the Second Circuit in *Helvering v. Walbridge,* 70 F. (2d) 683, certiorari denied 293 U. S. 594. In that case Walbridge had contributed to a partnership certain securities on which he already had a capital gain. These securities were sold by the partnership at an even higher price. The firm

paid the tax on the second appreciation and the Commissioner asserted a deficiency against Walbridge for a capital gain prior to the transfer. The Board of Tax Appeals held that Walbridge was taxable only upon liquidation of the partnership and depending on whether his share was greater or less than his original contribution. This was affirmed by the Circuit Court of Appeals, which held that the capital gain of an individual is not taxable until liquidation, saying in part, at page 684:

> "* * Ever since the Act of 1918 the Regulations had provided that only upon dissolution of the firm did the partner individually 'realize' any gain or loss on firm transactions, and at that time his gain was the difference between his liquidating dividend and the original cost to him of his contribution. Article 1570, Regulations 45, Act of 1918; article 1570, Regulations 62, Act of 1921; article 1603, Regulations 65, Act of 1924; article 1603, Regulations 69, Act of 1926; article 604, Regulations 74, Act of 1928. Indeed if the liquidating dividend was in kind, no gain was 'realized' until the property distributed was sold, a provision of doubtful validity except perhaps in cases where the dividend did not itself have any 'fair market value.'"

In *Selma Wertheimer,* 31 B. T. A. 407, stockholders of A. Guckenheimer & Bros. in 1921 irrevocably transferred their stock to trustees under agreement empowering trustees to sell the stock and apply funds to the settlement and payment of corporate debts and thereafter to distribute the residue *pro rata.* The stock was sold in 1921 and all debts were paid on or before January 21, 1926, when the trustees distributed a part of the residue of the trust *corpus* retaining part to defray expenses incident to proceedings for refund of Federal taxes. The Board held that the trust was not terminated

in 1926 and the loss, if any, sustained by the former stockholders could not be definitely ascertained until complete liquidation. The rule applying to losses should equally apply to gains.

Upon the death of Mr. Frick, the interests of the deceased partner, as well as those of his survivers, were capitalized. *Wood v. Wood, supra; Maurice L. Goldman, et al., Executors,* 15 B. T. A. 1341-1346; *Archbald, Jr., et al., Executors,* 4 B. T. A. 483.

Petitioner says in his brief (p. 42):

> "The article (1570) intends that the gain or loss on the partner's investment is to be determined only when he has completely severed his connection, both with the partnership and its assets."

With this statement we agree completely. It is and always has been our position that no taxable gain resulted to respondents until all the assets were sold when for the first time it could be determined whether respondents realized gain or loss upon their partnership investment. Respondents had not completely severed their connection with the partnership assets or the firm in 1920.

Petitioner also says (Brief, p. 62) that the record does not show that respondents had not received from the partnership assets their tax bases prior to 1920. The record shows that the receipts by respondents for 1920 were less than the total cost bases of their capital investment as officially determined by the Commissioner. This fact was not questioned at the trial. The Court found that "The sum received from the sale of whiskey certificates by A. Overholt & Company and West Overton Distilling Company in 1920, and prior thereto during the existence of the partnerships was less in amount

than the cost of the assets of said companies to the partners, H. C. Frick, A. W. Mellon and R. B. Mellon." (Fdg. 23, R. 154, 169). The petitioner does not even say that this finding is not true in fact or call attention to anything in the record to contradict it.

It was not necessary for the Court to find specific figures, although it could have done so if necessary. The record amply supports the Court's findings. The income tax return for 1925 of The Union Trust Company, as liquidating agent (Ex. Z, R. 489) shows the net income for that year and distributions to the Messrs. Mellon and Frick Estate of $69,257.57 as ordinary income (refund of floor tax and other income less loss from bottling, storage, etc.) and of $882,303.64 as profit on liquidation. The return contains a schedule showing the computation of the gain on dissolution. It begins with the base of the partners as of January 1, 1919, the date of organization of the partnership, giving each respondent a base of $1,414,027.51. The schedule itemizes the so-called profits and losses for each year, 1919 to 1925 inclusive, as shown by the books, and the adjustments made by the Commissioner, with a resultant capital account for liquidation. It then shows the liquidation distributions to respondents and the Frick Estate, applies the base of each, and arrives at a capital net gain for each respondent of $882,303.64. The return of the liquidating agent for West Overton Distilling Co. was similar in all respects except as to amounts. (Ex. AA, R. 490). Respondents picked up on their individual returns the respective amounts shown on the return of the liquidating agent. Exs. X, Y, R. 485-86).

The Commissioner, after examination and audit, made no change except (1) to eliminate from ordinary income the reported profit of $69,257.57 for the reason that he included that sum in the computation of capital

net gain on liquidation, (2) to increase the distribution in liquidation to each respondent by his one-third share of $100,000 distributed to employees in 1925, and (3) to decrease the base from the January 1, 1919 cost of each respondent's interest in the partnership as adjusted ($1,303,071.08) to the value of that interest on December 2, 1919, the date of Mr. Frick's death ($909,775.53), a decrease of $312,315.55. The adjustments made by the Commissioner resulted in a total increase in income of each respondent of $345,648.88. (Exs. BB, CC, R. 491-503).

In protest briefs filed June 21, 1928, the respondents accepted the Commissioner's computation of the liquidating profit including his determined base of $990,775.53 for A. Overholt & Co. and $60,505.66 for West Overton Distilling Company. (Exs. DD, EE, R. 504 g, 506 f). These bases were carried forward by the Commissioner into his notices of deficiencies for 1925 and thus became his official determination. (Exs. BB, CC, R. 491-503). The alleged profit of each partner for 1920 from the sale of whiskey certificates was $233,429.21 for A. Overholt & Co. and $46,853.73 for West Overton Distilling Company (Fdgs. 17, 5, R. 153, 150). The Circuit Court of Appeals so found (R. 711). These figures were accepted by the taxpayers and the tax was paid on this basis. They have never been questioned by either party.

However it was only necessary that the Court find the "ultimate facts upon which the law must determine the rights of the parties." *United States v. Sioux City Stock Yards Co.,* 167 F. 126 (C. C. A. 8); *Anglo-American Land, M. & A. Co. v. Lombard,* 132 F. 721 (C. C. A. 8), cert. denied, 196 U. S. 638 (both opinions by Judge Van Devanter). The findings of the trial court should "not be a recital of evidence or of circumstances which

may tend to prove the ultimate facts or from which they may be inferred." *Raimond v. Terrebonne Parish,* 132 U. S. 192, 220.

The determination of the Commissioner is presumed to be correct (*infra,* p. 70), and no evidence was introduced to contradict it. Petitioner knows that the amount received in 1920 was less than the cost basis and he is only attempting to raise a technicality which is without merit. In any event, the question cannot now be raised.

This Court has frequently held that findings of fact concurred in by the two lower courts will be accepted by the Supreme Court unless clear error is shown. In *United States v. Commercial Credit Co.,* 286 U. S. 63, 76 L. Ed. 978 (1932), the Court said:

> "* * * The two courts below are in agreement as to the inferences fairly to be gathered from the facts, and their findings are not to be disturbed unless clearly erroneous."

See also *United States v. Chemical Foundation,* 272 U. S. 1, 71 L. Ed. 131 (1926); *Second Russian Insurance Co. v. Miller,* 268 U. S. 552, 69 L. Ed. 1088 (1925); *L. E. Waterman Co. v. Modern Pen Co.,* 235 U. S. 88, 59 L. Ed. 142 (1914).

The cases relied upon by petitioner are not in conflict with our position.

Rossmoore v. Anderson, 1 F. Supp. 35 (S. D. N. Y.), affirmed 67 F. (2d) 1009 (C. C. A. 2), cert. denied 292 U. S. 630, involves an entirely different situation. In that case, a partnership was dissolved by agreement on November 1, 1920. All of the capital except a reserve of $5,000 for expenses was distributed and apparently

all capital contributions were returned in full. In 1921 the sole assets of the firm consisted of moneys to be received for services rendered and to be rendered in the completion of contracts already made. The Court said that the money in question "presumably was earned after dissolution." As the capital distribution had been made prior to the receipt of the income in question, of course the money received for services could only be income. It was not derived from a sale of capital assets but from personal efforts of the partners. The question the Court decided was not whether the income was taxable, which seems to have been admitted, but whether it was taxable to the partner or his assignees. There was no question before the Court of possible losses chargeable against capital. In the present case there was no continuance of the partnership business in 1920 but merely the sale of assets in dissolution. Article 1570 of Regulations 45 was not mentioned in the Rossmoore opinion and probably was not called to the attention of the Court as it did not apply to that situation.

Roney v. Commissioner, (C. C. A. 4), 67 F. (2d) 165, is not in point. It is not the case of a partnership in liquidation as the result of dissolution caused by the death of a partner. Roney and his partner, Shapira, were engaged in buying and scrapping distillery properties. They bought a number of distilleries, including the Gynnbrook Distillery. It was purchased in 1919. In 1920, the plan changed and the partners secured a permit from the Government and *actively distilled whiskey for sale*. The Court held that the whiskey was thus held primarily for sale—under the statutory definition of capital assets contained in Section 101 of the Revenue Act of 1928. But that definition applies only to transactions occurring after December 31, 1921, and has nothing whatever to do with the question as to whether

such assets become capital assets when a partnership is dissolved by the death of a partner and the partnership assets are in process of liquidation. See Revenue Act of 1921, Section 206 (a) (1), and Acts of 1924 and 1926, Section 208 (a) (1).

If, in our case, the respondents had engaged actively in making whiskey, if they were a "going concern," if there were no question of dissolution of the partnership, if *all* the assets had been sold in 1920, and if the transactions occurred after December 31, 1921, then the *Roney* case would be comparable. The situation there before the Court is entirely different from ours and the principle of the case is in no way applicable.

Renziehausen v. Lucas, 280 U. S. 387, 74 L. Ed. 501, involved an *individual,* not a partnership, who contended that part of the whiskey in his warehouses was a personal investment and therefore a capital asset, but the Supreme Court said that the "whole business was his" and was part of his stock in trade. Here again, the statutory definition of capital assets, under the Revenue Act of 1921, excluding stock in trade, is applicable, and is not to be confused with a situation existing prior to that Act. This case is even farther removed in point of principle and fact than the *Roney* case, *supra.*

Earle v. Commissioner (C. C. A. 1), 38 F. (2d) 965, holds only that income earned prior to dissolution by death, is taxable, even though the partner's death occurred prior to the end of the tax year, and the gain realized thus became part of the capital assets. To be comparable to the *Earle* case, the items in question here would have to be income earned prior to the death of Mr. Frick and not in the year following his death. The admitted profits at issue in the *Earle* case arose from a sale

made on June 14, 1923. One partner died on July 1, 1923. Not only that, but the June sale was of all the assets, which were taken over by a corporation which assumed all the debts. The facts in the case (practically conclusive on appeal), are set forth in the findings of the Board (15 B. T. A. 668, 669, 670). In the opinion of the Board (Phillips, Member), we find this comment (p. 671):

> "It appears that the net income of the partnership * * * was some $70,000, all of which had been earned prior to the death of Eugene V. Earle. *The partnership was not only terminated in 1923 by the death of this partner, but its affairs were liquidated in that year by transferring all its assets to a corporation,* which assumed all of the obligations and liabilities of the partnership. This transfer, however, was not of the nature which could give rise to a taxable gain or deductible loss. Section 202, Revenue Act of 1921. The taxable year of the partnership being the same as that of the partners, the liquidation having been accomplished within the year without gain or loss, and all of the profits of the year having been accrued and received by the partnership prior to its termination by the death of a partner, *there are not here involved those questions which arise where the partnerships and the individual partners have different accounting periods, where losses are sustained during the period of liquidation, or where liquidation is not completed within the taxable year.*" (Italics ours).

The above statement distinguishes the case. All else is outside the present discussion. The *Earle* case is therefore without force here.

Burnet v. Sanford & Brooks Co., 282 U. S. 359, merely decided that the method of reporting income by

yearly periods, adopted by the company for 1913 to 1916, inclusive, properly reflected income on an annual basis. The income arose from a dredging contract. The years 1913, 1915 and 1916 showed net losses. These were recouped by a judgment in 1920 against the United States on the dredging contract (for misrepresentation of borings made part of the specifications). (Cf. *United States v. Atlantic Dredging Co.,* 253 U. S. 1). There was no question of dissolution or of profit on liquidation. Indeed, the case is authority for respondents, as it contains this significant statement by Mr. Justice Stone, at page 363 of the opinion:

> "That the recovery made by respondent in 1920 was gross income for that year within the meaning of these sections cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not *capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income.* See Doyle v. Mitchell Bros. Co., 247 U. S. 185, 62 L. Ed. 1059, 38 S. Ct. 467, supra." (Italics ours).

Guckenheimer & Bros. Co. v. Heiner (W. D. Pa. not reported) has been rightly distinguished by the learned trial judge in his opinion in the instant case (R. 159). There are distinguishing points other than those given in his opinion. In that case there was some miscellaneous operating income, comparable to the "bottling and

sale of barrels" income in this case, which was returned originally by each of these plaintiffs, on which a tax was paid, and which is outside this case. There was no segregation of that sort of operating income from the moneys derived from capital operations. Consequently, the Court found itself "unable from it (the claim), or from the testimony, to give plaintiff relief from its indefinite claim." The Trial Judge was generally inclined in favor of the plaintiff's argument, however, for he said: "The second claim of the plaintiff has undoubtedly much inherent force." In our cases, the force is positive. A tax has been paid on the miscellaneous or current income (so-called) and it is out of this suit. The tax that the court found should be refunded is on the "capital" part which the Guckenheimers failed to segregate but which was clearly separated in the present cases.

The petitioner cites Section 218 (a) of the Revenue Act of 1918 (Appendix, page 96), which applies by its own terms only to "individuals *carrying on business* in partnership." As before stated respondents were not carrying on business in partnership but were liquidating a partnership dissolved by the death of Mr. Frick, as was necessary under the Uniform Partnership Act of Pennsylvania. Article 1570 prescribes the manner and method of computing tax on liquidation of a partnership, while Section 218 prescribes the manner and method of computing tax on the current income of a partnership actively conducting business. Section 218 (a) of the Revenue Act of 1918 levies a tax on the distributive share of each partner whether distributed or not. Here there was no distributive share and therefore no taxable income, and Article 1570 provides that no tax shall be levied in such a case until final distribution. The individual partners were not entitled to cur-

rent earnings of the partnerships in liquidation until liquidation had been completed.

The argument that taxation of a dissolved partnership in the manner determined by the District Court "may distort the Government's tax receipts from year to year" (Petitioner's Brief, p. 49), is certainly fallacious when we consider how few partnerships are dissolved by death of a partner and liquidated. The small amount involved in comparison with the billions of dollars of annual Government income makes the income tax on such dissolutions of no importance from the standpoint of Government receipts.

Neither the Revenue Acts nor *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, decide that any taxpayer must pay a tax every year to "assure a regular flow of income to the Government." As pointed out in this brief (pp. 18-19), there are many instances in which taxable profit is deferred in items similar to this and even if deferred will not distort the Government's tax receipts from year to year. If such should be the case, the remedy is by statute or a new regulation which the Treasury Department has not yet considered necessary.

Petitioner's statement (Brief, p. 49) that the decision of the District Court will constitute a dangerous precedent by affording a "loophole for tax evasion" is unwarranted. There are no facts in the record nor in the findings of the Court to support such a statement. On the contrary the evidence shows conclusively the lack of any intention to avoid payment of a tax, let alone to evade tax. The remedy, if any is needed, is a change in the rule established by the regulation and is legislative and not judicial. This argument, introduced in this Court for the first time, is untenable and without merit. The fact is that respondents made full disclosures of the

transaction and paid a tax on the same income in two separate years when assessments were made by the Commissioner. Surely an attempt to recover one of the taxes so paid cannot be called "tax evasion." This case turns on its own particular facts and the decision does not present an opportunity either for the avoidance or evasion of taxes by others in the future. *There is no principle involved in this case other than the application of a regulation promulgated by the Commissioner himself.*

Petitioner says that the settlement with the Frick Estate, in which it was determined that as to it the income in question was taxable in 1925, is inconclusive since it may show merely that the Commissioner erred in determining the tax due from the Frick Estate. Certainly all partners are taxable on the same basis, and the petitioner, who so frequently calls in his brief for equitable treatment, cannot contend that it is equitable for the Government to settle with the Frick Estate on one theory and later claim from the other partners a tax on another and different basis when it has, in the meantime, collected a tax from the other partners on the same basis as that paid by the Frick Estate. The cases cited by petitioner in this connection relate to income taxes on profits from a continuing business. They deal with the question of what income is chargeable to the individual and what portion to the estate, and not with the question of a profit on the sale of capital assets as in this case. We know of no authority which holds that on a sale or liquidation of capital assets of a dissolved partnership, a deceased partner's share is taxable on a different basis than that of any other partner.

The petitioner, in his brief (p. 26), argues that a partnership must file tax returns until its affairs are

terminated. There is no requirement to this effect. It may, under the law, be necessary to file information returns during liquidation but the filing of these returns does not require the payment of tax by the dissolved partnership or necessarily by the surviving partners as individuals. Petitioner also argues that the same rule as to the payment of income tax during liquidation should apply to a partnership in liquidation as to an individual who is selling out his own business. This is an entirely different situation and was recognized by the Treasury Department when it adopted Article 1570. An individual is entitled to the proceeds of the sale whereas the surviving partner, as trustee for the decedent, is only entitled to his distributive share, if any, upon complete liquidation. On dissolution there are no current earnings of the partners from the sale of capital assets until the investment of the individual partners is returned.

While a partnership may not be recognized as a taxable entity, yet it is a legal entity and has a status entirely separate from that of the individual partners. A corporation has another status. It is a separate taxable entity while a partnership is not, and the Treasury Department has recognized this by adopting regulations putting a partnership on a different basis, both when it is carrying on business and when it is dissolved.

The law imposes various duties on liquidating partners as to the collection and sale of assets, the payment of debts and final distribution. The liquidating partners could not carry on the business in the manner in which it was carried on by the partners prior to Mr. Frick's death. Before he died, it was an ordinary partnership and its business could be conducted in any way that the partners agreed. After his

death the surviving partners were liquidating trustees and their actions with respect to the partnership property had to be conducted in accordance with the direction of the statutes and decisions of the Courts.

The return filed for 1920 classed as income taxable to the partners, money received from bottling, storage, etc., the current operations of the partnership, but did not include the funds realized from the sale of capital assets. In other words, so far as the current business of the partnership was concerned, the liquidating partners were willing to and did pay tax on the profits as income to them and the tax assessed and paid on such profits is not involved in these actions. There is doubt, however, as to whether even the income from bottling, storage, etc., was taxable income for the year 1920. Even the Commissioner expressly ruled otherwise, holding that all profits during liquidation were taxable in 1925 when the remainder of the property was sold (Ex. 6, R. 605; R. 328, 341-42; Exs. BB, CC, R. 491, 497).

We do not contend that on dissolution a partner's interest in the firm is converted into a specific interest in the assets of the partnership, but there can be no doubt that his interest in the whole partnership is capitalized and until the liquidation returns to him the cost of his interest, he has received no taxable income from it. The debts must be paid before he receives anything, and how can he be taxed on an alleged profit which may never come to him because it must be used to pay partnership obligations? For this reason, the proceeds of sales of certificates during liquidation are not current nor operating earnings as stated in the petitioner's brief (p. 45), and no taxable income is realized until such earnings are paid to the partners and represent profits to each partner on his partnership investment.

The Government's brief proceeds on the premises that the sale of the warehouse certificates resulted in current "operating profit." It has been shown that there can be no operating profit from the sale of a capital asset of a partnership in liquidation, taxable to the surviving partners until the selling price of all such assets exceeds the cost basis of the partners' interest. The petitioners use of the words "operating profit" is misleading. "Operating" necessarily means the carrying on of a process of buying and selling, manufacturing and selling, barter and trade—a continuous process. It cannot logically, or on the basis of sound reasoning, be said to include the sale of such capital assets, there being no continuing process and no opportunity for replacement for the purpose of continuing trade or manufacture or sale. There can be no operating profit in the liquidation of non-replaceable capital assets. The surviving partners were not carrying out a scheme for profit making, the essential feature of a business.

In *Wood v. Wood, supra,* the Supreme Court of Pennsylvania held that a partnership is dissolved by death of a partner; that interest on bonds and dividends on stock owned by the partnership at the time of dissolution were not profits "produced by partnership trade, for that had ceased;" that from and after date of death of a partner "partnership trade was ended; such business as was done, * * * was merely for the purpose of winding up the firm affairs."

We submit that no taxable income from any source was realized from the liquidation of A. Overholt & Co. or West Overton Distilling Company during the year 1920; that the whiskey certificates sold during 1920 in connection with the liquidation of the former partnerships were capital assets and until the proceeds ex-

ceeded the cost of the interests to the partners, which did not occur until final liquidation in 1925, there was no taxable gain.

II.

The Surviving Partners of A. Overholt & Co. and West Overton Distilling Company Were Trustees for the Liquidation of the Partnerships.

Mr. Henry C. Frick, one of the partners, died on December 2, 1919. During the year 1920 A. W. Mellon and R. B. Mellon, as surviving partners, were liquidating the former partnerships. Their legal status is fixed by the laws of the State of Pennsylvania.

The death of Mr. Frick dissolved the partnerships. *Uniform Partnership Act* (Act of March 26, 1915, P. L. 18, Purdon's Pa. Stat. Ann. Title 59):

> "Section 29. The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on, as distinguished from the winding up, of the business.
>
> "Section 30. On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.
>
> "Section 31. Dissolution is caused:
>
> * * * * * *
>
> "(4) By the death of any partner;
>
> * * * * * *
>
> "Section 33. Except so far as may be necessary to wind up partnership affairs, or to complete transactions begun but not then finished, dissolution terminates all authority of any partner to act for the partnership, * * * ."

Froess v. Froess, 284 Pa. 369, 373; *Clarence B. Davison,* 20 B. T. A. 856; *John L. Hall,* 25 B. T. A. 1; *R. W. Archbald, Jr.,* 4 B. T. A. 483; *Maurice L. Goldman,* 15 B. T. A. 1341.

It will be noted that Section 29 definitely distinguishes between a dissolution by death or withdrawal of a partner and a voluntary winding up of the business. Petitioner's argument seems to lose sight of this distinction.

The partnership agreements contemplated dissolution by death of a partner, providing: "In case of the dissolution of the firm by death of one or more of the partners, * * *" (Exs. A, B—Statements of Claim, R. 15-19, 321).

The articles of agreement of January 31, 1921, recited in part:

> "WHEREAS, on the 2nd day of December, A. D. 1919, said copartnership was dissolved by the death of said Henry C. Frick; and
>
> "WHEREAS, said copartnership has been in the process of liquidation since the date of the death of said Henry C. Frick; * * *" (Exs. C, D, Statement of Claim; R. 19-23, 323).

Notwithstanding that the partnerships had not terminated (Sec. 30 of said Partnership Act, *supra*), the surviving partners thereupon became liquidating trustees of the two former partnerships, with the duty of accounting as trustees upon the completion of the liquidation. *Froess v. Froess,* 284 Pa. 369, 289 Pa. 69; *Eisenlohr's Estate* (*No. 1*), 258 Pa. 431; *Brown's Appeal,* 89 Pa. 139.

In *Froess v. Froess,* 284 Pa. 369, 373, the Supreme Court of Pennsylvania said:

> "Admittedly, the partnership was dissolved by the death of the copartner. That this result followed appears by the Uniform Partnership Act (March 26, 1915, P. L. 18, section 31), and it was equally true before that legislation became effective; Shipe's App., 114 Pa. 205; Mamaux's Est., 274 Pa. 533; Underdown v. Underdown, 279 Pa. 482. After the death, it became the duty of the survivor to settle the partnership affairs, and all authority on his part ceased, except such as was necessary for the winding up of the business, or completing transactions then begun, but not yet finished (Partnership Act, section 33). * * * *It is the duty of the liquidating partner to account as trustee for assets which come into his hands* (20 R. C. L. 1003; Leary v. Kelley, 277 Pa. 217; Hay's App., *supra*), and, on cause shown, as here, the court may direct that this be done: Partnership Act, section 37; Underdown v. Underdown, 270 Pa. 229." (Italics ours).

As such liquidating trustees, the surviving partners were not required to liquidate and wind up the affairs of the former partnerships at once but were entitled to have a reasonable time within which to do so. What is a reasonable time is largely within the discretion of the court and all the circumstances are to be given consideration. In view of the uncertainty of the whiskey business, the restrictions on its use for medicine only, the restrictions on sale, the increasing hazards of the business, such as robbery, complete destruction by contemplated confiscatory laws or regulations, taxes, etc., the liquidation of these two partnerships was seasonably done, exceptionally well handled and managed, and a period of six years' time was, under all the circum-

stances, not unreasonable. This is not disputed by petitioner. See *Hall v. City Park Brewing Company*, 294 Pa. 127.

The continuance of the partnership "until the winding up of partnership affairs was completed" did not mean that it was in existence for all purposes as though it had not been dissolved. It continued merely for the purpose of liquidation and subject to all laws relating to liquidation including Article 1570 of Regulations 45 heretofore cited. A partnership in dissolution is in no way similar to a corporation in dissolution. Under Article 1570 another and different rule is applied to the tax status of a partnership.

Petitioner's brief (p. 57) says that the partnership agreement provided "that the surviving partners *should* appoint a liquidating trustee," and from this he argues that because they did appoint such a trustee in 1921 after the tax year in question, the surviving partners never became liquidating trustees. The partnership agreement did not provide that the surviving partners should appoint a trustee but merely gave them discretionary power to do so, and the fact that they delayed for a year in taking this step certainly under the law of Pennsylvania, left them acting as such trustees during 1920.

Petitioner's brief (p. 57) says in substance that even if the respondents were surviving trustees, it does not follow that they were required to be treated as trustees by the taxing authorities as the Federal statutes have their own criteria in such matters irrespective of local laws. There can be no doubt that the law of Pennsylvania governs in this case as to the dissolution of the partnership, the status of the surviving partners as

liquidating trustees, their duty to pay all debts before distribution and similar matters. These questions are to be determined by local law. When they have been so decided, then on that basis the question of Federal taxability is to be determined. *Freuler v. Helvering,* 291 U. S. 35, 78 L. Ed. 634 (1934); *Blair v. Commissioner,* 300 U. S. 5 (1937); *Group No. 1 Oil Corp. v. Bass,* 283 U. S. 279, 75 L. Ed. 1032; *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 393, 76 L. Ed. 815; *Poe v. Seaborn,* 282 U. S. 101, 75 L. Ed. 239; *Judson v. United States,* 15 F. Supp. 62 (Ct. Cls.); *Leser v. Burnet,* 46 F. (2d) 756 (C. C. A. 4); *Cameron v. Commissioner,* 56 F. (2d) 1021 (C. C. A. 3); *Old Colony Trust Co. v. Commissioner,* 73 F. (2d) 970 (C. C. A. 1).

The lower court properly held that the surviving partners acted in respect to the assets of the former partnerships as liquidating trustees with a duty to account to the Frick Estate. (R. 159).

III.

Under the Laws of Pennsylvania, the Surviving Partners as Liquidating Trustees Were Unable to Make Any Distribution in Liquidation Until All Present and Contingent Liabilities Had Been Paid, Satisfied or Adequately Provided For.

Under the law of Pennsylvania no distributions could have been made by the liquidating partners until all debts and liabilities, contingent or otherwise, had been paid or satisfied or other provision made therefor, and under such circumstances neither the surviving partners nor the estate of the deceased partner could legally be taxed on any income from the sale of partnership assets until final distribution, whether such assets be considered capital assets or not. The *Uniform Part-*

nership Act provides (Act of March 26, 1915, P. L. 18, Sec. 40, 41 (8), Purdon's Pa. Stat. Ann. Title 59):

> "Section 40. In settling accounts between the partners after dissolution, the following rules shall be observed, subject to any agreement to the contrary:
>
> * * * * * *
>
> "(b) The liabilities of the partnership shall rank, in order of payment, as follows:
>
> "I. Those owing to creditors other than partners,
>
> "II. Those owing to partners other than for capital and profits,
>
> "III. Those owing to partners in respect of capital,
>
> "IV. Those owing to partners in respect of profits.
>
> * * * * * *
>
> "Section 41.
>
> * * * * * *
>
> "(8) When the business of a partnership after dissolution is continued under any conditions set forth in this section, *the creditors of the dissolved partnership, as against the separate creditors of the retiring or deceased partner or the representative of the deceased partner, have a prior right to any claim of the retired partner or the representative of the deceased partner against the person or partnership continuing the business,* on account of the retired or deceased partner's interest in the dissolved partnership or on account of any consideration promised for such interest or for his right in partnership property." (Italics ours).

In 47 *Corpus Juris* 1169, it is said:

> "Firm obligations must be paid out of the firm assets before any partner's share can be ascertained,

and therefore before any partner is entitled to any part of the assets, and this rule applies in determining the interest of a retiring partner."

In the case of *Herron v. Wampler,* 194 Pa. 277, cited in *Froess v. Froess,* 284 Pa. 369, the Supreme Court stated that distribution of the net surplus of partnership assets *is the final step in the winding up of a partnership business.*

In the case of *Powell v. Bennett,* 30 N. E. 518 (Ind. 1892), the Court said:

"We are of the opinion, however, that the court erred in overruling the motion of the appellant for a new trial. It is conceded by the briefs before us that the partnership debts are not paid. It was as necessary to prove on the trial that the partnership debts were paid as it was to allege it in the complaint. Page v. Thompson, 33 Ind. 137; Briggs v. Daugherty, 48 Ind. 247; Lang v. Oppenheim, 96 Ind. 48. In the case of Page v. Thompson, *supra,* which was an action by one partner after the partnership business had ceased, to recover his part of a debt due the firm, this court said: *'The plaintiff had no right, either at law or in equity, to put any part of it in his private pocket until the creditors of the firm were satisfied. It cannot be useful to cite authorities on so plain a proposition.'* * * * *What we do decide is that, until the creditors are paid, no member of the firm can recover, for his own use, any part of the partnership assets.'* (Italics ours).

The *Powell* case has been cited and approved in *Shrum v. Simpson,* 57 N. E. 708 (Ind. 1900), *Bond v. May,* 78 N. E. 260 (Ind. 1906), and *Adams v. Carmony,* 87 N. E. 708 (Ind. 1909).

In *Lawson v. Dunn,* 57 Atl. 415 (N. J. Equity 1904), the Court said (p. 416):

> "It is quite clear that the claims of the partners cannot be recognized until the *other claimants* are paid in full." (Italics ours).

The Board of Tax Appeals in the case of *R. W. Archbald, Jr.,* 4 B. T. A. 483, said, in discussing the liquidation of a partnership (p. 485):

> "* * * *Its debts must be paid, its accounts must be collected, its contracts must be performed, its assets must be sold or distributed in kind and all of its business affairs must be terminated and disposed of.*" (Italics ours).

In *Oyster v. Short,* 177 Pa. 594, the Court held that it was not disputed that under the general rule applicable to liquidation that partners or members of a firm could not participate in the distribution until the creditors had been provided for.

There was uncontradicted and unimpeached testimony that there were large accounts payable on January 1, 1920 (Ex. 2; R. 350) and large contingent liabilities of the partnerships existing in 1920, sufficient to stop absolutely any thought of distribution at that time. These contingencies were (a) the possibility of a floor tax being levied on the whiskey by the Government, (b) the possibility of being required by the Government to remove the whiskey to a concentration warehouse and payment of tax, and (c) the possibility of being required by the Government to bottle all whiskey and pay the tax immediately. If any of these contingencies had materialized, the surviving partners would have been required to spend large sums of money. (R. 369-73).

In addition to the contingencies mentioned, the Government was proposing to assess additional income

taxes for the years 1916, 1917 and 1918 against the two corporations, A. Overholt & Co. and West Overton Distilling Company, for which taxes the partnerships were liable, in an approximate aggregate amount of $550,000, which taxes were not finally settled until 1928. In 1920 this fact was well known to the Government. (R. 374-79).

In view of the circumstances of this particular case, it cannot be disputed that any distribution by the liquidating trustees to the surviving partners or the representatives of the deceased partner prior to the final settlement of the affairs of the dissolved partnership, would have been unauthorized and in plain violation of the duties of the liquidating trustees.

IV.

If the Former Partnerships Realized Any Taxable Income in 1920, It Was Income to the Liquidating Trustees and Taxable to Them as Separate Entities.

A. THE SURVIVING PARTNERS WERE LIQUIDATING TRUSTEES, TAXABLE AS SEPARATE ENTITIES.

Whether we consider the surviving partners taxable individually or as liquidating trustees, we contend, for the reasons heretofore stated, that no taxable income was realized in 1920 from the liquidation of said partnerships.

But if this Court should consider that taxable income was realized in 1920 from the sale of whiskey certificates, in that event the judgment should be affirmed on the ground that the liquidating trustees were separate taxable entities, that the tax, if any, was due and payable by such separate taxable entities and not by

respondents as individuals, or beneficiaries of the trusts, and the assessment and collection thereof against the trustees is now barred by lapse of time. The District Court held this alternative point is moot. Affirmance by this Court of the District Court's position will take this point out of the case entirely.

In the Revenue Act of 1918, Congress adopted a comprehensive scheme of taxation and provided in different sections for the assessment of taxes against individuals, against corporations, against fiduciaries (with exceptions), and also provided for the filing of returns of income for partnerships, personal service corporations and fiduciaries, although the tax on the income shown therein might be assessed against some other taxable entity. Such latter returns are commonly known as information returns. There is little difference between Form 1041, which is an information return by a trustee, and Form 1065, which is a partnership information return. Each shows the income and the amount distributable. In the case of partnerships the tax on the income is paid by the individuals, not by the partnerships. If a fiduciary return had been filed in this case, it also would have been only an information return, but a "return" nevertheless, and the Commissioner would have assessed the same tax, as his decision was based on a legal position and not on the form of the return.

Every fact in this case was known to the taxing authorities in 1921 when the 1920 return was filed. There were attached to the return of each partnership, full information schedules. The Bureau, very early in the history of this case, was advised of every *fact* in numerous Revenue Agent's reports (Exs. K, L.), examinations, audits and conferences, and at a time when the Com-

missioner had timely control of every right now alleged in his defense. This will be discussed more fully later in the brief.

The purpose of a return of income is well stated in *Hartford-Connecticut Trust Co. v. Eaton* (C. C. A. 2), 34 F. (2d) 128, which held that no penalty for failure to file a return is to be imposed where any return or list is filed, from which the requisite information may be derived. Circuit Judge Augustus N. Hand there said (p. 130):

> "the provisions for imposing penalties do not seem to require a taxpayer to choose the right blank at his peril, when he acts in good faith and makes a full disclosure of his income."

In the present case the return filed left blank the answers to the questions "Kind of business" and "State whether partnership or corporation" and stated the facts with respect to the death of Mr. Frick and that

> "* * * Messrs. A. W. and R. B. Mellon were, as surviving partners, required to carry on the liquidation of the assets of the copartnership." (R. 351 d).

The returns showed every fact necessary to raise the "trust" question and put the Commissioner on notice. So did the reports of the Revenue Agents made in 1921 (Exs. K, L; R. 448, 450). Responsibility for the legal solution of the question by the Commissioner, if erroneous, rests solely on the Commissioner's shoulders. (See cases cited on p. 61 hereof).

The fact that the respondents did not raise the legal question in their early briefs and protests is of no importance. Non-action does not amount to acquiescence and failure to protest does not affirm an error in law.

Petitioner could not have been and was not misled by the returns and therefore did not rely to his prejudice on any factual representations made by respondents.

As said in the *Tide Water Oil Company* case, 29 B. T. A. 1208, 1224:

> "* * * The Commissioner frequently corrects his interpretation of the taxing statutes. The petitioner could likewise abandon its interpretation of the law and adopt the correct one."

In *Bowers v. New York Trust Co.* (C. C. A. 2), 9 F. (2d) 548, 551, the Court said:

> "* * * Nobody estops himself into paying taxes by failing in the past to assert his full rights."

The whole intent of Sections 219, 225 and 200 of the Revenue Act of 1918 (Appendix, pp. 73-75) is that the tax shall be paid by the fiduciary of any trust except where the income has been distributed periodically to the beneficiaries, in which case the beneficiaries shall pay the tax. It contemplates that the fiduciary shall have all deductions to which an individual would be entitled.

Article 342 of Regulations 45 provides that in the case of a trust the income is taxed to the fiduciary as to any single individual except that from the income of a decedent's estate or a trust there may first be deducted any amount of income properly paid or credited to a beneficiary. In the instant case no income of the liquidating trustees was distributed or distributable in 1920.

Under the laws of the State of Pennsylvania the liquidating trustees of a partnership are fiduciaries of a trust within the meaning of those terms as used in the Revenue Act of 1918. The Revenue Acts make no dis-

tinction between express trusts and trusts created by operation of law. The Revenue Act of 1918 provides:

> "Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including— * * *."

The word "including" is a word of enlargement, not of restriction. *Pinellas Ice Co. v. Commissioner,* 287 U. S. 462, 470. If Congress had intended the section to apply to express trusts only, it would have said so. Section 225 applies to *every fiduciary* except receivers. Section 200 defines "fiduciary" to be:

> "The term 'fiduciary' means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate; * * *."

Those provisions are certainly broad enough to cover the fiduciary of a trust created by operation of law.

The legal situation of the surviving partners with respect to the partnership assets was exactly as if they had transferred partnership assets to trustees under an agreement empowering the trustees to sell the assets and to apply the funds to the settlement and payment of partnership debts, federal tax liabilities, etc., and distribute the residue pro rata.

That a fiduciary is a separate taxable entity is now well settled. *Bankers' Trust Co. v. Bowers,* 295 Fed. 89, 23 F. (2d) 941; *Woolley et al. v. Malley,* 30 F. (2d) 73, rev'g 18 F. (2d) 668, cert. denied 279 U. S. 860; *Merchants' Loan & Trust Co. v. Smietanka,* 255 U. S. 509, 65 L. Ed. 751; *Jobes v. Crooks,* 33 F. (2d) 1016; *Busch v. Commisisoner,* 50 F. (2d) 800.

In a trust in which the income is added to the corpus and held for later distribution, the trustee must return the income, which is taxable to the trust and not to the beneficiary. If, therefore, the income from the sale of certificates in 1920 was taxable for that year, it was taxable to the trusts of which the liquidating partners were fiduciaries and not to the individual partners, and it is now too late to assert the tax against the fiduciaries.

In the preliminary argument (Brief, pp. 68-74, and Appendix B, pp. 105-112) to the argument on equitable defense, the Government now argues (1) that the collection of a tax from the liquidating trustees as separate taxable entities is not barred by any statute of limitations (p. 73); (2) that if such collection is barred, then respondents are not entitled in equity and good conscience to recover in these cases.

The question of the running of the Statute of Limitations is raised for the first time in this Court. It was not pleaded or argued by petitioner in the District Court and was not mentioned in the specifications of error argued in the Circuit Court of Appeals. It was not raised in the petition for the writ nor in the specifications to be urged and will not be considered in this Court. *Helvering v. Taylor,* 293 U. S. 507. Moreover, the petitioner expressly pleaded that "if said organizations were taxable trusts, as now contended by plaintiffs, the Commissioner of Internal Revenue and the United States are now precluded from assessing and collecting the aforesaid tax liabilities * * *" (R. 87, 116), and such pleadings were received in evidence, having been admitted in the respondents' replies (R. 388-90, 397-98). Since the United States is bound by the admissions of its counsel, *Tucker v. Alexander,* 275 U. S. 228. it is certainly

bound by its sworn pleadings. All parties assumed (and, we believe correctly) that the Statute had run and that no tax could now be assessed against the partners as liquidating trustees, if such action were now proposed. It is clear that if the Statute has run the delay in final action was not due to respondents but wholly to the Commissioner's office, which held the 1920 return from 1921 to 1927 before acting on it and held the 1925 return until 1928 before acting, and finally took until 1932, after suit was brought, to return to its original position and attempt to retain the tax for the year 1920.

B. RESPONDENTS ARE NOT ESTOPPED TO CONTEND THAT THE TAX FOR 1920, IF ANY, WAS PAYABLE BY THE LIQUIDATING TRUSTEES AND NOT BY THE INDIVIDUAL PARTNERS.

In the District Court petitioner filed amended affidavits of defense (R. 64-90, 93-120) raising as new matter the additional defenses of estoppel and recoupment. The District Court held that the facts did not sustain the defense of estoppel and that the defense of recoupment was met by the finding that the 1920 partnership gain was not distributed or distributive and that the equitable defenses raised only moot questions (R. 161). The Circuit Court affirmed, holding there were no grounds for applying the doctrine either of legal or equitable estoppel (R. 711). While not using the words "estoppel" and "recoupment" in this Court, petitioner raises the same questions as he did in the lower courts under the statement that "in equity and good conscience respondents are not entitled to recover."

This equitable defense must be considered only in the event that the Court should determine that the alleged 1920 income from the sale of whiskey certificates,

if any, was taxable to the respondents as liquidating trustees and as separate entities.

Respondents were assessed and paid a tax on alleged profits for 1920, and again were assessed and paid a tax on the same alleged profits for the year 1925. The District Court and the Circuit Court of Appeals have held that the alleged profits of 1920 were profits taxable in 1925. The Government has exacted and twice has received the tax on the same income. When it refuses to refund the tax paid for 1925, how is it possible for petitioner to contend that the respondents are not equitably entitled to recover the tax paid on the same income for 1920? The tax having been paid on the income realized in 1925, no tax is due for 1920 on account of such income, and there is nothing to recoup, this being true whether or not the liquidating trustees are taxable as separate entities. The petitioner has been fully satisfied.

This equitable defense seems to rely largely on *Stone v. White,* 301 U. S. 532, which is cited fifteen times in the latter portion of petitioner's brief. Therefore, at the outset of the answer to this defense we will call attention to the differences between *Stone v. White* and the present case.

The decision in *Stone v. White* was based solely upon equitable principles, the Court saying that there was only one tax due and the question was merely whether the tax should be paid by the trustee or by the beneficiary. An effort was being made to avoid payment of any tax on the income, either by the trustee or by the beneficiary. In the present case, a tax on the same income has been paid twice by respondents, due to two different assessments made by the Commissioner on the same income at different times and for different years.

In the present case, there is no identity of interest between the trustee and the *cestui que* trust as there was in *Stone v. White,* for the respondents as surviving partners were not entitled to all the income of the trust. Cf. *Sewell v. United States,* 19 Fed. Supp. 657 (Ct. Cl.); *Schlemmer v. United States* (C. C. A. 2), reported at 384 C. C. H. ¶ 9041. The respondents are not the "apparent" as well as the "real" taxpayers. The Frick Estate was the owner of a one-third interest in the partnerships, and hence the beneficiary to the extent of one-third of the assets, income and proceeds of sale. Moreover, the Frick Estate is now out of the picture, a settlement having been made with it by the Commissioner in 1927, and the entire estate was thereafter distributed. Therefore, any tax now assessed on the trust would have to be paid by the two remaining partners, without contribution from the estate.

The quotation in petitioner's brief (p. 75) from the opinion in *Stone v. White* does not apply to the present case for the following reasons:

(1) The retention of the tax would result in an unjust enrichment to the Government.

(2) Respondents did not avoid their just share of the tax burden as they have paid a tax on the same income in 1925.

(3) An injustice will be done to respondents if they are not permitted to recover the tax paid in 1920 and consequently to settle the tax claim on the same basis as the Frick Estate, namely—that the income was taxable in 1925.

(4) The reference to the error of the taxing authorities being excusable in view of judicial declarations, does not apply to the present case as the Commissioner does not claim to have relied on any decision of any court.

(5) The Government in these cases has taken with both its right and left hands and refuses to tender return by either.

With full knowledge of all facts, the Government changed its position twice and assessed a tax on the same income in two different years, placing a double tax burden on the respondents. In this instance the taxing authorities are to blame and not the respondents as the double payment was due to the double assessment; the taxing authorities are the sole cause of the situation; and if respondents are not entitled to recover, there will be an unjust enrichment to the Government, which has *at all times declined and still declines to refund or tender refund of the tax, paid on the same income, either for 1920 or 1925* although in justice and equity a refund should be made for one of the years. *Bull v. United States,* 295 U. S. 247.

The running of the Statute of Limitations in this case was not due to any fault of the respondents but solely to the delay of the taxing authorities in making up their minds as to the year in which the income was taxable, the record showing that the claim for refund of the 1920 tax, for which these suits were brought, was not filed until after the Commissioner assessed a tax for 1925 on the same identical income and was not rejected until two years after the present suits were instituted. The equities in this case are all on the side of the respondents and the principles stated in *Stone v. White* are not in conflict with their position.

This Court in *McEachern v. Rose,* decided on November 8, 1937, distinguished that case from *Stone v. White,* saying with respect to *Stone v. White*:

"* * * The Commissioner neither sought, nor did Section 322, regardless of any period of limita-

> tion, permit him to credit the amount which the one taxpayer had paid against the tax which another should have paid. *Equitable considerations not within the reach of the statutes denied a recovery. It was enough, in the peculiar facts of the case, that the trustees had suffered no burden and that the Government was not unjustly enriched."* (Italics ours).

Stone v. White is again distinguished in *Lyman v. United States,* decided by the District Court for the District of Massachusetts on January 28, 1938 (reported in 384 CCH ¶ 9079). There the court reviewed the facts in *Stone v. White* and the legal history of the taxation of income of similar trusts, and said: "I consider that decision to be limited to the peculiar facts of the case." The court further said:

> "* * * If, either the beneficiary of the trust, or the Government is to suffer a loss, in good conscience and equity, that loss should be borne by the Government, since its failure to assess a tax against the trust must be deemed to border on negligence for it was acquainted with the set-up of the trust instrument."

These cases recognize the principle which we are urging in the present case. Equitable consideration certainly does not permit the Government to assert a tax against the trustees at this time. If it should be permitted to do so, the trustees would "suffer a burden" as they would have to bear the whole tax, the estate of H. C. Frick having been settled and fully distributed, and the Government would be "unjustly enriched" because it would be permitted to retain two taxes on the same income assessed for different years.

There Has Been No Conduct, Acts, Language Or Silence On The Part Of The Respondents Amounting to Misrepresentation Or Concealment Of Material Facts.

Equitable estoppel is an affirmative defense and the party evoking such equitable estoppel has the burden of proof to show that all the elements of such estoppel exist. *Helvering v. Brooklyn City R. Co.*, 72 F. (2d) 274; *Tide Water Oil Co.*, 29 B. T. A. 1208; *Sugar Creek Coal & Mining Co.* 31 B. T. A. 344; *Bamberg Cotton Mills Co.*, 8 B. T. A. 1236, 1244.

The record shows that at all times from the filing of the returns in 1921 until the present date both parties were equally possessed of the facts regarding the death of Mr. Frick and the liquidation of the two partnerships. These facts were clearly reflected in the returns filed for the former partnerships of A. Overholt & Co. and West Overton Distilling Company. (Exs. 3, 4; R. 351, 352.) The Commissioner's representatives examined the books and records of respondents and of the two former partnerships and at all times had access thereto. There was no misrepresentation of any fact material to this issue, nor of any other fact. There was a frank disclosure of all the underlying facts upon which the Commissioner could at any time have determined the correct taxpayer. How can the petitioner say, in good conscience, that either he or the Commissioner was misled by respondents?

There was at most a mutual misunderstanding of the law respecting partnerships in liquidation and the taxable liability of the liquidating trustees, and it did not occur to either party that the assessment and collection of tax on the respondents and the estate of the deceased partner might be erroneous as a matter of law,

until after the Commissioner refused to refund the tax for either 1920 or 1925, at which time respondents were forced by his unfair and inequitable action to make a thorough review of their legal rights, with the consequent development of the correct manner and method as a matter of law of assessing and collecting a tax for 1920 if any was due. There is no evidence on which the Court could find that respondents attempted to or did mislead the taxing authorities in any way as to any fact.

Under these facts, the authorities are clearly against petitioner's position. *Brant v. Virginia Coal & Iron Co.*, 93 U. S. 327, 335; *Southwestern Investment Co.*, 19 B. T. A. 30 and authorities there cited; *Tide Water Oil Co.*, 29 B. T. A. 1208; *Helvering v. Brooklyn City R. Co.* (C. C. A. 2), 72 F. (2d) 274.

We submit that petitioner has failed to prove any misrepresentation or concealment, and therefore there can be no estoppel.

There Is No Estoppel Where Both Parties Labor Under A Mutual Mistake Of Law.

The situation here arose solely because of both parties' misunderstanding or mistake of law. Both parties knew and had immediate access to all records necessary to determine the underlying facts from which the correct legal conclusion could be drawn. Both parties were equally charged with knowledge of the law and hence neither is bound by estoppel.

The Commissioner, knowing that Mr. Frick had died and that the partnerships were in liquidation, chose to treat the surviving partners, acting as liquidating trustees, and the estate of the deceased partner as members of a continuing partnership and assessed and collected

taxes on that basis. The Commissioner was bound to know the law. He is bound to make his own interpretation of the law and to ascertain all facts. The determination of the correct tax for 1920 was a statutory requirement imposed on him, and neither he, nor the taxpayer, nor both together, can depart from the statutory law. He is required by statute and by regulation to investigate, examine and audit returns (Revenue Act of 1918, Sec. 250 (b); Sec. 1317 amending R. S. 3176; Art. 1012 of Regulations 45), and he has no right to rely on a taxpayer's statement or understanding or position as to the law of the case. *Tide Water Oil Co.*, 29 B. T. A. 1208; *Sugar Creek Coal & Mining Co.*, 31 B. T. A. 344; *Summerfield Co.*, 29 B. T. A. 77; *Helvering v. Brooklyn City R. Co.*, 72 F. (2d) 274; *McIlhenny et al., Executors v. Commissioner*, 39 F. (2d) 356; *Essex Coal Co. v. Commissioner*, 39 F. (2d) 892; *Glavey v. United States*, 182 U. S. 595, 45 L. Ed. 1247; *United States v. Andrews*, 240 U. S. 90, 60 L. Ed. 541; *Dixon County v. Field*, 111 U. S. 83, 28 L. Ed. 360.

In *Helvering v. Salvage*, 297 U. S. 106, 109, the Supreme Court said:

> "* * * Further, that the failure to disclose 1922 taxable gain apparently resulted from innocent mistake of law; there was no false representation of fact; nothing gave support to the claim of estoppel."

In the *Estate of William Steele*, 34 B. T. A. 173, 175, the Court said:

> "* * * We have heretofore held that no estoppel can be predicated on a mistake of law in the absence of some misrepresentation of fact. * * * The rationale of the rule is that everyone being presumed to know the law, the Commissioner is not justified in relying upon the taxpayer's in-

terpretation thereof, and reliance is an essential element of estoppel. The Commissioner is duty bound to think and act for himself and make his own interpretations of the law. *Tide Water Oil Co., supra.*"

In *Commissioner v. Union Pacific R. R. Co.,* 86 F. (2d) 637 (C. C. A. 2), 1936, the question before the Court on appeal from the Board of Tax Appeals was whether profit and loss from certain sales included in the 1926 income were properly allocable to 1917 and 1920. The Commissioner claimed that the respondent was estopped from saying that the income was taxable in years other than 1926. The Court of Appeals refused to affirm this position, saying (p. 639):

> "It is argued by the petitioner that the respondent is estopped from making its present claims. An estoppel cannot originate in a mere statement of law or in silence due to an error of law. Moreover, the person claiming the benefits of estoppel must appear ignorant of the true facts and be adversely affected by the acts of the person against whom the estoppel is claimed. 'Estoppel is not an element of income but only a doctrine affecting a liability.' Sugar Creek Coal & Mining Co. v. Commissioner, 31 B. T. A. 344, 346. One who pleads estoppel has the burden of establishing all its elements. Brewerton v. United States, 9 F. Supp. 503 (Ct. Cl.) Here the Board concluded that the failure to report the sales was due to an error both of the taxpayer and of the Commissioner, and there is evidence supporting this conclusion. Under these circumstances, the doctrine of estoppel may not be applied. Salvage v. Com'r, 76 F. (2d) 112 (C. C. A. 2), affirmed Helvering v. Salvage, 297 U. S. 106, 56 S. Ct. 375, 80 L. Ed. 511; Jamieson v. United States, (D. C.) 10 F.

Supp. 321; *contra,* Commissioner v. Farren, 82 F. (2d) 141 (C. C. A. 10). In the Salvage Case, the purchase of stock was not reported in the proper year, yet the taxpayer was allowed to use the cost basis for that year in determining the gain derived from the redemption of the stock. Only an innocent mistake of law was proved, and we held it immaterial that an assessment for that year was barred by the statute of limitations. We commented on Crane v. Commissioner, 68 F. (2d) 640 (C. C. A. 1), and expressed our disagreement with certain views there announced. An unqualified application of the rule that failure to report income creates estoppel would mean that an equitable remedy can serve to nullify the substantive provisions of the statute of limitations as well as the statutory policy that income is to be allocated to its appropriate year, Burnet v. Sanford & Brooks Co., 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383, despite the loss of revenue, Helvering v. St. Louis S. W. Ry. Co., 66 F. (2d) 633 (C. C. A. 8).

* * * * *

"It is nowhere stated that the taxpayer made any misleading statements or concealed the facts, and it is not denied that the interest payments under both contracts of sale were reported in the returns for the respective years. It thus appears that the petitioner did not rely upon the respondent's conduct. The Board was justified, and so are we, in assuming that the petitioner was advised of the facts and merely overlooked their legal significance. Sugar Creek Coal & Mining Co. v. Commissioner, *supra*; cf. Helvering v. Brooklyn City Ry. Co., 72 F. (2d) 274 (C. C. A. 2)."

The doctrine thus illustrated and applied in these tax cases is in accordance with the usual rule obtaining in all civil litigation. If both parties are equally cognizant of the facts, and the action taken was under a mistaken idea of the law, the party so acting cannot say he was deceived thereby and there is no estoppel.

The Party Claiming Estoppel Must Have Been Led By His Reliance On The Conduct Of The Other To Change His Position To His Detriment.

This broad rule is an essential element of all estoppels, and it is so firmly established that it requires no citations for its support. It is made up of two elements. There must be a detrimental change of position and such change must have come from reliance on the conduct of the party against whom estoppel is claimed. He must have acted with reason, and reasonably, and he cannot claim reliance when prudence and intelligence would have dictated a different course. Here neither the Commissioner nor the petitioner may claim reliance on any representation of respondents, not only because the parties were acting under a mistake of law, but also because both were in complete possession of the underlying facts and because there was no misrepresentation or concealment, and lastly, because the change of position by the Commissioner was made, not in reliance upon the position taken by respondents, but directly contrary thereto. In other words, the Commissioner's change of position took place in 1928 and 1929 and consisted in his determination that all the profits should be taxed in 1925 upon final liquidation as capital gain. This was the position originally taken by respondents when the returns for 1920 were filed, and when the returns were examined the Commissioner refused to agree with it and required

the payment of a tax in 1920. There was never any change of position by him as the result of any position taken by respondents, and as we have hereinbefore shown, he is not, as a matter of law, entitled to rely upon a position of law taken by a taxpayer. He was not only free to take a different view and proceed in accordance with the law but was in duty bound to think and act for himself—and did so by twice changing his position.

The Object Of The Doctrine Of Estoppel.

The object of this doctrine is well stated in the *Tide Water Oil* case, 29 B. T. A. 1208, 1224:

> "The object of the rule providing for estoppel is to repress fraud and render men truthful in their dealings with each other. Under that rule *the author of the misfortune* may not himself escape the consequences and cast the burden upon another. Thus the equitable rule of estoppel presupposes an error or fault of some kind by the party estopped, and implies an act in itself invalid. Merchants' Bank v. State Bank, 77 U. S. 604, 645; Brant v. Virginia Coal & Iron Co., 93 U. S. 327, 335; Henshaw v. Bissell, 85 U. S. 255. Whatever doctrine analogous to estoppel the respondent would invoke, it must be founded upon some act or omission of the petitioner for which in equity it should be held to account. The equities must be strong enough to overshadow the law. There is here no suggestion of fraud, untruthfulness, concealment, misrepresentation, omission, negligence, violation of duty, or unfair conduct on the part of the petitioner. It was no more the author of the misfortune than was the Commissioner. The latter was in as good a position as the former to make all proper decisions. Thus, in this case there is no occasion for applying either

the doctrine of estoppel or any doctrine analogous thereto." (Italics ours).

The author of the misfortune in this case is not these respondents but the Commissioner himself. It is a fair inference from the facts (the claim for refund of 1920 tax not having been filed until after the Commissioner reversed his position and included the identical income again in 1925) that if the Commissioner had not changed his position and had not attempted, contrary to honesty and good faith, to collect and retain taxes in two years on the identical income, respondents might not have discovered that as a matter of law the income, if any, in 1920 should have been taxed to the liquidating trustees as separate taxable entities. The equities in this case are all with the respondents. The petitioner is pleading equity, that is, an estoppel, merely because the Statute of Limitations has run against the separate taxable entities for the year 1920, when at the same time he refuses to refund the tax paid on the same income in 1925. Such a plea is not strong enough to overshadow the equities in favor of respondents or to overshadow the law. It is to be remembered when weighing the equities that this record shows that the Commissioner has collected a tax on the same identical income in two separate years, that there are claims for refund, protective only, pending and which have been pending for years, and *there has been no tender on the part of the Commissioner to refund the tax for either year.* The petitioner seeks to retain double benefits. He cannot disaffirm liability to refund the 1920 tax whilst retaining the benefits of the collection in 1925.

As a matter of fact respondents have accepted the determination of the Commissioner that the income in question was taxable income in the year 1925. The claims for refund for 1920 were filed four days after such deter-

mination and show such acceptance. The Commissioner's representatives were advised of such acceptance in the late summer of 1927.

It is to be noted that the Commissioner, after determining in 1929 that no profits were realized until final liquidation in 1925, did not revert to his original position that taxable profits were realized in 1920 until after this litigation was begun. This he cannot do. See *Ohio and Miss. Ry. Co. v. McCarthy,* 96 U. S. 258, 268, 24 L. Ed. 693, 696.

When the Commissioner, who is charged with the statutory duty of ascertaining the correct tax, the correct taxpayer and the assessment thereof, makes a mistake of law, he has no redress at law or in equity if the Statute of Limitations bars assessment and collection against the correct taxpayer unless there has been fraud, misrepresentation, concealment or waiver by the taxpayer. (Cf. *McEachern v. Rose, supra,* where it is held that statutory provisions override equities).

In *Grand Central Public Market, Inc. v. United States,* decided by the District Court for the Southern District of California on January 12, 1938, and not yet officially reported (see 384 CCH ¶ 9048), there is an excellent discussion and analysis of the late cases dealing with estoppel, election and recoupment. The question was whether advance payments for the execution of leases were taxable income in the year of receipt or in the year in which the lease became effective. The court held that bonuses received in the years 1925 to 1928 as advance payments on a lease to take effect in 1929 were not income in 1929 but were income in the prior years although not reported by the taxpayer and although the Statute of Limitations had expired for the earlier years

where the evidence showed that both the Commissioner and the taxpayer were at times undecided as to the proper years in which the bonuses or advance payments were taxable. In its opinion, the court said:

> "Should the taxpayer be penalized for doing, with regard to 1925 income, what the Commissioner —with all of the facts before him—thought proper as to 1931 income? If the law, the regulations, and the current practice, with regard to the reporting of that income, were such that both the Commissioner and the taxpayer were deceived as to the proper years in which the bonuses were taxable the contention surely cannot be made successfully that the taxpayer deceived the Commissioner.
>
> "Is the taxpayer presumed to have the ability to interpret the law more accurately than the Commissioner, so that what was the error of the Commissioner was the deceit of the taxpayer? We think the answer must be in the negative; it is of course fundamental that estoppel cannot be predicated on errors of judgment by the person asking its benefit. (*Helvering v. Salvage,* 297 U. S. 106 * * *)"

In *S. F. Scott & Sons, Inc. v. United States* (D. C. Mass.), November 17, 1932, and not reported, aff'd 69 F. (2d) 728 (C. C. A. 1), a tax for 1918 due and paid by Scott as an individual was later assessed against and collected from a corporation which was organized in 1919. Thereafter the tax paid by Scott was refunded. The corporation sued to recover and was successful. The Court said:

> "There is no equity in this case. S. F. Scott took advantage of the option given him by Section 330, and now the corporation seeks to recover the tax which it paid, alleging various reasons for supporting its unjust demand. *Unfortunately one of*

the reasons is compelling. The Department taxed the wrong taxpayer. Artemus Ward, Inc., 21 B. T. A. 1096; Murphy Dillon Co., 23 B. T. A. 1320; Sadowsky v. Anderson, 29 F. (2d) 677, 678; Clift & Goodrich, Inc. v. U. S., 56 F. (2d) 751, 752; Dreyfus Dry Goods Co. v. Lines, 24 F. (2d) 29.

"The corporation did not owe the tax, as it was not in existence in the year 1918, for which the tax was laid. *The Department must follow the rules of law. The Department ran the wrong way with the ball, and it cannot complain because the rules require that a score be imposed against it rather than in its favor. The corporation was not off-side* (*there was no misrepresentation of fact*—Murphy Dillon Co., 23 B. T. A. 1320; Gott v. Live Poultry Transit Co., 153 Atl. Rep. 801, 805 (Del.)) so the score must stand." (Italics ours.)

V.

The Tax Liability of Respondents for 1925 Has Been Officially Determined by the Commissioner.

The Government argues (Brief, pp. 89-93) that the tax liabilities of respondents for 1925 have not been finally determined and cannot affect its affirmative defense. It forgets that that defense is based on what it now terms to be "equity and good conscience," relying almost entirely on the decision of this Court in *Stone v. White,* hereinbefore distinguished. How can a litigant plead in defense "equity and good conscience" when it retains taxes assessed and collected on the same identical income in two different taxable years and refuses to refund or even tender the tax for either year?

If the Government had made a tender of refund for the tax for 1925 it might have some standing in a court

of equity. But it does not come into this Court "with clean hands" as it has refused to do equity and, therefore, it cannot avail itself of an equitable defense.

The statement that the liability for 1925 has not been finally determined by the Commissioner is contrary to the statutes and decisions. The Commissioner on March 15, 1929, made a determination that all profit was realized upon final liquidation in 1925 and taxable in that year (Exs. BB, CC; R. 491, 497), and that determination is his official statutory determination. That determination is *prima facie* correct. *United States v. Rindskopf,* 105 U. S. 418; *Welch v. Helvering,* 290 U. S. 111, 115.

The filing of a claim for refund does not alter the fact that the Commissioner has made his official determination nor destroy the presumption of correctness attached thereto.

The Government attempts further to becloud the issue by referring (Brief, pp. 92-93) to proffered evidence rejected upon objection, as to which no assignment of error has been made in this Court, a practice never countenanced. Statements outside the record are made that the claims for refund of the 1925 taxes filed by the respondents for their own protection have not been acted upon in order to protect the interests of the Government; but if the Government were turning "square corners" with its taxpaying citizens, *Howbert v. Penrose* (C. C. A. 10) 38 F. (2d) 577, 581 (see *Kansas City Southern Railway Co. v. Commissioner,* 75 F. (2d) 786, 790-91), it would have long since considered those claims for refund and, if it thought the Commissioner had erred in either 1920 or 1925, it would have made the proper adjustments and tendered refund of either the 1920 or the 1925 re-

sultant overpayment or reversed its position as to 1925 and rejected the refund claims.

Never has it been possible for respondents to get the Commissioner to take a definite and final position on this tax question. Never has the Commissioner said that if the Court holds that the alleged earnings were taxable in 1920, he will refund the tax paid on the same earnings in 1925. He is obviously trying to hold the money received for each year and consequently to have collected a tax on the same income for two separate years. The Government now says in its brief (p. 91), "It cannot be assumed, however, that a refund will be due for 1925, whatever the outcome of these cases," and intimates that the Commissioner will make a redetermination of respondents' tax liability on a basis which we may well assume will be satisfactory to him and will show no payment due to the respondents. The Commissioner has had many years to make the refund for 1925, or to redetermine the tax liability for that year, if he so desired, and his delay and his failure to take any action has served to prejudice respondents and it is the best evidence of lack of good faith.

Under all the attendant circumstances disclosed by the record in these cases, the plea of "equity and good conscience" comes with ill grace from a sovereign government, has no merit and should be disregarded.

Conclusion.

The ultimate findings of the lower courts are supported by the evidence and the judgments are supported by the findings.

No taxable income was realized by respondents in 1920. If it be held that taxable income was realized in

1920 from the sale of whiskey certificates, it was realized by, assessable against and taxable to, the surviving partners of the dissolved partnerships as trustees, separate taxable entities, and the tax thereon was illegally assessed against and collected from the respondents.

The Government failed to do equity and cannot rely on an equitable defense. None of the elements of estoppel was present in these cases and respondents are not barred from recovery.

The judgments below should be affirmed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1918, c. 18, 40 Stat. 1057:

"Sec. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, *of the net income of the partnership for the* taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

"The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership."

"Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

"(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

"(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

"(3) Income held for future distribution under the terms of the will or trust; and

"(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

"(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, * * *"

"Sec. 225. That every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife, or $2,000 or over if married and living with husband or wife, or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a non-resident alien, stating specifically the items of the gross income and the deductions and credits allowed by this title. Under such regulations as the Commissioner with the approval of the Secretary may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be a sufficient compliance with the above requirement. The fiduciary shall make oath that he has sufficient knowledge of the affairs of such individual, estate or trust to enable him to make the return, and that the same

is, to the best of his knowledge and belief, true and correct.

"Fiduciaries required to make returns under this Act shall be subject to all the provisions of this Act which apply to individuals."

"Sec. 200. That when used in this title—

* * *

"The term 'fiduciary' means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;"

* * *

Treasury Regulations 45:

"Art. 1570. Readjustment of partnership interests.—When a partner retires from a partnership, or it is dissolved, he realizes a gain or loss measured by the difference between the price received for his interest and the cost to him or (if acquired prior thereto) the fair market value as of March 1, 1913, of his interest in the partnership, including in such cost or value the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid. If, however, the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received on distribution. See article 1566. Whenever a new partner is admitted to a partnership or any existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain

or loss has been realized by any partner. See also article 1563."

"Art. 1521. ***Fiduciary.***—'Fiduciary' is a term which applies to all persons that occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators, and a fiduciary for income tax purposes is a person who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest or receives and controls income of another as in the case of receivers. A committee of the property of an incompetent person is a fiduciary. See sections 219 and 225 of the statute and articles 341-344 and 421-425."

SUPREME COURT OF THE UNITED STATES.

Nos. 144, 145.—October Term, 1937.

144 D. B. Heiner, Petitioner, vs. Paul Mellon, et al., Executors.	On Certiorari to the United States Circuit Court of Appeals for the Third Circuit.
145 D. B. Heiner, Petitioner, vs. Jennie King Mellon, et al., Executors.	

[May 16, 1938.]

Mr. Justice Brandeis delivered the opinion of the Court.

These cases, tried below in the federal court for western Pennsylvania and argued together here, arise from the same facts and present the same questions of law. Each action was brought against D. B. Heiner, as former Collector of Internal Revenue and individually, to recover an amount paid under protest by the taxpayer in 1927 upon a deficiency assessment of his 1920 income tax. The amounts taxed as additional income were the distributive shares of certain profits alleged to have been earned by each in 1920 as a partner in two firms. Due demand for a refund was made. In No. 144 the taxpayer was A. W. Mellon; in No. 145, R. B. Mellon. Both having died, the suits are by their executors. In No. 144, the District Court entered judgment for $202,502.22 with interest (14 F. Supp. 424); in No. 145 for $187,787.17 with interest. These judgments were affirmed by the Court of Appeals (89 F. (2d) 141). Certiorari was granted because of alleged conflict as to applicable rules of law important in the administration of the revenue laws. 303 U. S. —.

There is no dispute as to the relevant facts. Prior to December 12, 1918, A. W. Mellon, R. B. Mellon and H. C. Frick each owned one-third of the entire capital stock of two distilling corporations—A. Overholt & Company and West Overton Distilling Company. On that day those three individuals formed

two partnerships in which each partner was to have a one-third interest. In January 1919 they caused to be transferred to the partnership called A. Overholt & Company all the assets of the corporation of that name; and to the partnership called West Overton Distilling Company, all the assets of that corporation. These assets included large whiskey inventories in bonded warehouses. Neither corporation had distilled any whiskey after 1916. Liquidation of the businesses of each had been started by the two corporations in 1918; and the partnerships had been organized for the purpose of liquidating them. The business of each partnership in 1920, had, like its business in 1919, consisted in the sale of whiskey certificates and the storage, bottling, casing and sale of the stock of whiskey. It was not until 1925 that the assets of the partnerships then remaining were sold in bulk, and the proceeds distributed among those entitled thereto.

Frick died December 2, 1919; but throughout 1920 the businesses of A. Overholt & Company and of West Overton Distilling Company were conducted, and their books were kept, in the same manner as the businesses had been conducted and books had been kept by the partnerships in 1919, and by the corporations in 1918. For 1920 the partnership returns of the two concerns disclosed facts from which it appeared that substantial gains had been made from the sale of whiskey. But the amounts were not reported as income of the partnerships; and neither A. W. Mellon nor R. B. Mellon included in their income tax returns for 1920 any amount on account of them. The Commissioner of Internal Revenue determined that these sums were distributive profits; that the returns of taxable income of A. W. Mellon and of R. B. Mellon for the year 1920 should have included one-third of the profits in that year of each firm from the sale of whiskey; and made a deficiency assessment on A. W. Mellon of $190,419.70 and on R. B. Mellon of $175,259.70.

The Revenue Act of 1918[1] governs taxation of 1920 income. Section 218(a) of the Act provides that individuals carrying on business in partnership shall be liable in their individual capacities for the income tax on profits earned therein, and that in computing the net income of each partner there shall be included his distributive

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1 Act of February 24, 1919, c. 18, 40 Stat. 1057.

share, whether distributed or not, of the net income of the partnership for the taxable year. Section 224 provides that the partnership shall file an informational return setting forth the items of its gross income, the deductions allowed and the distributive share of net income to which each partner is entitled.

The two Mellons filed their individual returns for 1920, and also the informational partnership returns for that year. While the Mellons claimed that they were not taxable on their share of the profits from whiskey sold in 1920, they recognized that they were taxable for their shares of these other profits of the concerns earned in 1920. The partnership returns in the case of each concern showed a gain arising from storage, bottling and casing operations, sales of barrels, interest and rentals. One-third of each of these profits was entered by each of the Mellons in his individual return as his distributive share of the profits of the two partnerships.

First. The primary question for decision is whether the net profits made by the two partnerships in 1920 from the sales of whiskey were in their nature taxable income. Throughout 1920, A. Overholt & Company and the West Overton Distilling Company were engaged in business. The mere fact that the purpose of the partnerships was to liquidate the assets taken over from the corporations is not of legal significance. Profits made in the business of liquidation are taxable in the same way and to the same extent as if made in an expanding business. Nor is it of legal significance that the liquidation was not completed until 1925 and that until completion of the liquidation it could not be known whether the business venture, taken as a whole, had been profitable. The federal income tax system is based on an annual accounting.[2] Under that law the question whether taxable profits have been made is determined annually by the result of the operations of the year.

Purchasing real estate, subdividing and selling it in parcels is, in essence, a liquidating business. The claim has been repeatedly made that no income was realized until the investment was recouped; but the Board of Tax Appeals has uniformly held in accord with Article 43 of Regulations 45 (and later regulations) that the

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[2] Burnet *v.* Sanford & Brooks Co., 282 U. S. 359, 365; Burnet *v.* Thompson Oil & Gas Co., 283 U. S. 301, 306; Woolford Realty Co. *v.* Rose, 286 U. S. 319, 326; Brown *v.* Helvering, 291 U. S. 193, 198-99; Helvering *v.* Morgan's Inc., 293 U. S. 121, 126-127; Guaranty Trust Co. *v.* Commissioner, 303 U. S. —, — [decided March 28, 1938.]

cost of the real estate must be apportioned among all the lots, and income returned upon the sales in each year, regardless of the number of lots remaining undisposed of at the close of the tax year.[3] A like rule has been applied where the taxpayer had purchased personal property in a block and was engaged in selling it in parcels. The claim that there was no taxable income until the capital had been returned was rejected.[4]

The fact that it might prove that when the business was fully liquidated the profits of 1920 were offset by heavy loss of later years is immaterial. Losses suffered by a taxpayer in a later year may be deducted from profits, if any, earned by him in that later year; but the tax on a year's income may not be withheld because losses may thereafter occur. If A. Overholt & Company and West Overton Distilling Company had remained corporations they would have been obliged to make each year return of the profits made therein and pay taxes annually throughout the period of liquidation although it might ultimately prove that the losses of the later years exceeded the profits of the earlier ones.[5] Likewise, if the concerns had each been owned by a single individual, the fact that his sole business was liquidating the concern would not have relieved him from paying annually taxes on the net profits. No good reason is suggested why a different rule should apply to partnerships.

We conclude that gains from the sale of whiskey in 1920 were income of that year. The amount of the income was determinable

[3] J. S. Cullinan, 5 B. T. A. 996, 19 B. T. A. 930; Thomas J. Avery, 11 B. T. A. 958; Brodie C. Nalle, 19 B. T. A. 427; Frederika Skinner, 20 B. T. A. 491. See also B. S. Roberts, 7 B. T. A. 1162; Hannibal Missouri Land Co., 9 B. T. A. 1072; P. C. Clarke, 22 B. T. A. 314, 325; Biscayne Bay Islands Co., 23 B. T. A. 731; Searles Real Estate Trust, 25 B. T. A. 1115. Compare Perkins *v.* Thomas, 86 F. (2d) 954, 956 (C. C. A. 5), affirmed on other grounds, 301 U. S. 665; see also Elmhurst Cemetery Co. *v.* Commissioner, 300 U. S. 37.

[4] Santa Maria Gas Co., 10 B. T. A. 1412; American Industrial Corp., 20 B. T. A. 188; Bancitaly Corp., 34 B. T. A. 494. Compare Weser Bros., Inc., 12 B. T. A. 1394; C. H. Swift & Sons, Inc., 13 B. T. A. 138; Deer Island Logging Co., 14 B. T. A. 1027; O. H. Himelick, 32 B. T. A. 792.

[5] See Regulations 45, Art. 547; Tazewell Elec. Light & Power Co. *v.* Strother, 84 F. (2d) 327 (C. C. A. 4); Northwest Utilities Securities Corp. *v.* Helvering, 67 F. (2d) 619 (C. C. A. 8); First Nat. Bank of Greeley *v.* United States, 86 F. (2d) 839 (C. C. A. 10). Compare Burnet *v.* Lexington Ice & Cold Storage Co., 62 F. (2d) 906 (C. C. A. 4); Taylor Oil and Gas Co. *v.* Commissioner, 47 F. (2d) 108 (C. C. A. 5); Hellebush *v.* Commissioner, 65 F. (2d) 902 (C. C. A. 6); Whitney Realty Co. *v.* Commissioner, 80 F. (2d) 429 (C. C. A. 6).

from the partnership books. Section 212(b) of the Revenue Act of 1918 provides that the net income shall be computed "in accordance with the method of accounting regularly employed in keeping the books of" the taxpayer, and it is not shown that the method employed clearly failed to reflect net income.

Second. The fact that the partnerships had been dissolved by Frick's death before 1920 does not affect the liability of the Mellons as surviving partners for income taxes on their distributive shares of the net profits made in that year. Compare *Rossmoore* v. *Anderson,* 1 F. Supp. 35 (S. D. N. Y.), affirmed, 67 F. (2d) 1009 (C. C. A. 2); *Rossmoore* v. *Commissioner,* 76 F. (2d) 520 (C. C. A. 2). The business of A. Overholt & Company did not terminate on Frick's death. Although dissolved, the partnerships and the business continued, since, as stated in the Pennsylvania Uniform Partnership Act: "On dissolution the partnership is not terminated, but continues until the winding up of the partnership affairs is completed."[6] Throughout the year 1920, the business of selling stock on hand and deriving income therefrom was carried on precisely as it had been theretofore, and for the same purpose. Article 424 of Regulations 45 recognizes that even in the hands of a receiver a partnership must file a return.

Third. The Mellons contend, and the court below held, that the partners' interests in the partnerships were capitalized upon dissolution, so that until the liquidation returned to them the cost of their interests, no taxable income was received; that Article 1570 of Regulations 45 so provides; and that this did not take place before 1925. But, as already pointed out, technical dissolution does not affect the liability of a partner under Section 218 for taxes on his distributive share of the partnership's income; and Article 1570 does not establish any rule that dissolution capitalizes the interest of a partner in future partnership profits. The article provides:

"When a partner retires from a partnership, or it is dissolved, he realizes a gain or loss measured by the difference between the price received for his interest and the cost to him or (if acquired prior thereto) the fair market value as of March 1, 1913, of his interest in the partnership, including in such cost or value the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which income tax has been paid. . . ."

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[6] Pa. Laws 1915, No. 15, § 30, Pa. Stat. Ann. (Purdon, 1930) Tit. 59, § 92.

This article is in no way inconsistent with the taxation of a partner on his share of the income of the partnership earned in a single year after dissolution but before completion of liquidation and distribution. It deals only with the determination of a partner's gain or loss on his investment when he completely severs his connection with the partnership and its assets. The gain or loss is determined substantially like that on any other business venture of the individual, treated as a whole. On the other hand, the profits from the sale of whiskey in 1920 were current income of the partnership for that year, not different in their nature from the profits from storage, bottling, casing, and similar operations which the Mellons returned as income. Article 1570 does not deal with this situation.

Fourth. The Mellons contend that because the partnerships were dissolved by the death of Frick in 1919, A. W. Mellon and R. B. Mellon, being surviving partners, became by operation of law liquidating trustees; that any income earned in 1920 from operations of the dissolved partnerships was income to the Mellons only in their fiduciary capacity as such trustees; that under Section 219 of the Revenue Act of 1918 the trust estate was a separate taxable entity; that if any income tax was due, it was therefore due from the trust, and that its assessment is now barred by the statute of limitations.

We do not find it necessary to determine whether assessment of the tax on this theory is now outlawed, or whether, as the Collector urges, recovery is precluded in any event under the doctrine of *Stone* v. *White*, 301 U. S. 532; for we are of the opinion that the Mellons are not trustees within the meaning of Section 219. The fact that they may be so denominated by the law of Pennsylvania is not conclusive. It is well settled that in the interpretation of the words used in a federal revenue act, local law is not controlling unless the federal statute "by express language or necessary implication, makes its own operation dependent upon state law." "The state law creates legal interests, but the federal statute determines when and how they shall be taxed." *Burnet* v. *Harmel*, 287 U. S. 103, 110.[7] We think it is clear that under the circumstances set

[7] See also Burke-Waggoner Oil Association *v.* Hopkins, 269 U. S. 110, 113, 114; Palmer *v.* Bender, 287 U. S. 551, 555-56; Thomas *v.* Perkins, 301 U. S. 655, 659; Biddle *v.* Commissioner, 302 U. S. —, —. Compare Chicago Board of

forth, the income earned in 1920 was income of a partnership "carrying on business" within the meaning of Section 218 rather than of a trust under Section 219.

The obligation of the Mellons to pay, under the federal law, taxes on the profits made in 1920 from sales of whiskey is in no way affected by their fiduciary obligation under the law of the State to account to the Frick estate for its interest in the two partnerships being liquidated. The surviving partners continued during 1920 to conduct the business from which they earned profits. On such income the federal law required that taxes be paid. It did not require that the payments be made from the partnership assets. How the assets shall be disposed of, and what shall be done with the proceeds when realized, are matters which may be determined by the law of the State or by agreement of the partners. But however the assets are required by the law of the State to be disposed of, or the proceeds applied, the federal law requires that taxes be paid if, in disposing of them within the year the business is conducted and profits are made.

Fifth. The Mellons contend that under the law of Pennsylvania no distribution of profits could lawfully have been made by the surviving partners as liquidating trustees until all debts and liabilities, contingent or otherwise, had been paid or satisfied, and the partners' capital returned; and that although the business of the partnerships had been carried on after dissolution precisely as before, and the partnership accounts for the year 1920 showed large profits earned, their respective shares of them were not distributable and could not be deemed taxable income of the partners.

Section 218(a) of the Revenue Act of 1918 provides that "There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. . . ." If "distributive" meant "currently distributable under state law", the contentions made by the Mellons might have some force. But it does not.

Trade *v.* Johnson, 264 U. S. 1, 8-11; United States *v.* Robbins, 269 U. S. 315, 327-28; Corliss *v.* Bowers, 281 U. S. 376, 378; Tyler *v.* United States, 281 U. S. 497, 503. See also Hart *v.* Commissioner, 54 F. (2d) 848, 851 (C. C. A. 1); Fidelity-Philadelphia Trust Co. *v.* Commissioner, 47 F. (2d) 36, 38 (C. C. A. 3); Rosenberger *v.* McCaughn, 25 F. (2d) 699 (C. C. A. 3); Eagan *v.* Commissioner, 43 F. (2d) 881, 883 (C. C. A. 5); Fritz *v.* Commissioner, 76 F. (2d) 460, 461-62 (C. C. A. 5).

Article 322 of Regulations 45 (and corresponding articles of subsequent Regulations) defines "distributive" as meaning "proportionate." Compare *Earle v. Commissioner*, 38 F. (2d) 965, 967-68 (C. C. A. 1). And Section 220 of the Revenue Act of 1918, taxing to the shareholders the income of a corporation improperly accumulating its gains and profits for the purpose of avoiding surtax, assumes that the two words are synonymous. The tax is thus imposed upon the partner's proportionate share of the net income of the partnership, and the fact that it may not be currently distributable, whether by agreement of the parties or by operation of law, is not material.[8] No claim is made that the proportionate interests of the surviving partners was improperly determined by the Commissioner.

Sixth. Finally, the Mellons contend that in 1928 and 1929 the Commissioner determined that no profit was realized until final liquidation of the partnerships in 1925, and that income taxes for that year have been collected on this theory and not yet refunded. The Commissioner's alleged change of position is not here important. It is not shown that refund of these taxes is now barred. Nor is it necessary for us to consider the cost to the Mellons of their interests in these partnerships, or whether the Mellons' 1925 income taxes were erroneously assessed and collected, or whether the Commissioner correctly settled the tax liability of the Frick estate. None of these questions has any bearing upon the determination of the case before us.

Reversed.

Mr. Justice CARDOZO and Mr. Justice REED took no part in the consideration or decision of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.

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[8] Compare Earle *v.* Commissioner, 38 F. (2d) 965 (C. C. A. 1); Hill *v.* Commissioner, 38 F. (2d) 165, 168 (C. C. A. 1); Pope *v.* Commissioner, 39 F. (2d) 420 (C. C. A. 1); Ruprecht *v.* Commissioner, 39 F. (2d) 458 (C. C. A. 5); Benedict *v.* Price, 38 F. (2d) 309 (E. D. N. Y.); W. Frank Carter, 36 B. T. A. 60. See also O. D. 187, 1 C. B. 174.